Quarterly Journal

Interpretations —
January 1 to March 31, 2004

Interpretations—January 1 to March 31, 2004

978—December 4, 2003

12 CFR 4.31

[Summary: Letter denies a request for a Suspicious Activity Report (SAR) for use in private litigation because the public policy against disclosure, as reflected in congressional enactments, agency regulations, and recent court decisions, is very strong.]

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Subject: *Commerce Bank, N.A.* v. *Smith, No. 02-3226 (Bankr. W.D.N.C.)*

Dear Mr. Schaaf:

This responds to your letter seeking a Suspicious Activity Report (SAR) under 12 CFR 4.31 *et seq.* for use in the above referenced litigation.

I regret that I must deny your request. The public policy against disclosure of a SAR is very strong. Under 31 USC 5318(g)(2), a SAR is confidential. Congress recently buttressed this policy by amending the statute to provide that no officer or employee of the federal government, or of any state, local, tribal or territorial government who knows that a SAR was filed, may disclose to any person involved in the transaction that the transaction has been reported, other than as necessary to fulfill the employee's official duties. 31 USC 5318(g)(2)(A)(ii), as amended by the USA Patriot Act of 2001, Pub. L. No. 107-56, 351(b), 115 Stat. 272, 320-21 (2001). Similarly, regulations issued by the OCC and FinCen underline the confidentiality of a SAR. 12 CFR 21.11(k); 31 CFR 103.18(e), respectively. The state and federal courts have been virtually unanimous in emphasizing the confidentiality of a SAR. *See Int'l Bank of Miami, N.A.* v. *Shinitzky,* 849 So. 2d 1188 (Fla. 2003); *Matkin* v. *Fidelity Nat'l Bank,* 2002 WL 32059740 (D.S.C. 2002); *Cotton* v. *PrivateBank & Trust Co.,* 235 F. Supp. 2d 809 (N.D. Ill. 2002) (collecting cases). The courts have been equally insistent that even the act of filing of a SAR is confidential. *Lee* v. *Bankers Trust Co.,* 166 F. 3d 540, 544 (2d Cir. 1999) ("[E]ven in a suit for damages based on disclosures allegedly made in an SAR, a financial institution cannot reveal what disclosures it made in an SAR, or even whether it filed an SAR at all").

The applicable statute and agency regulations are predicated on the belief that, absent confidentiality, banks would be reluctant to file SARs, or would hesitate to describe fully the suspected misconduct. Moreover, the willingness of banks to make these filings will be diminished if SARs are made freely available to private litigants. The Congressional interest in not discouraging banks from filing SARs is reflected in the safe harbor provision that protects banks from suit, 31 USC 5318(g)(3)(A). *See Stoutt* v. *Banco Popular de Puerto Rico,* 320 F.3d 26, 30-31 (1st Cir.

2003), a recent decision that refused to read into the safe harbor provision a requirement that the bank filing the SAR do so in good faith. The failure of financial institutions to liberally report all evidence of suspicious activities may diminish the SAR's importance in serving as a weapon in the fight to prevent terrorists from accessing the banking system. Finally, since a SAR contains unproven allegations, its disclosure could unfairly impugn the integrity of any individual named therein and might even subject the reporting party to retaliation. *U.S.* v. *Holihan,* 248 F. Supp.2d 179, 185 (W.D.N.Y. 2003).

Ford Barrett
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979—December 18, 2003

12 USC 84

[Summary: Letter interprets the common source of repayment test in 12 CFR 32.5(c)(1) and finds that, on the specific facts presented, the test does not result in the combination of loans to members of the Indian Community with loans to other members or with a loan to the Community.]

Subject: Applicability of Lending Limit to Loans to [ ] Indian Community of *[city, state]* and its members

Dear [ ]:

I am writing in response to your request for our opinion as to the application of the lending limit, 12 USC 84, to loans *[NB, city, state]* (bank) has made, and plans to make, to [ ] Indian Community of *[city, state]* (Community) and to members of the Community. Based on the information in your letter and in subsequent telephone conversations, it is my opinion that for purposes of the lending limit a loan to one member would generally not be combined with a loan to another member, and that loans to members would generally not be combined with loans made to the Community.

Facts

The Community is located on the south side of the [ ] in [ ] County, two miles south of *[city]* and 10 miles from the bank in *[city, state]*. The population resident on the [ ] acre reservation of the Community was approximately 300 in the year 2000.[1] The population of *[bank's city]* is approximately 1,300 and is largely dependent on the tribal enterprises run by the Community.

The bank has made a loan to the Community, the purpose of which is to finance several loans that the Community wishes to make to several members of the Community and to augment a loan fund from which the Community will make loans to other members. The loan to the Community is secured by an assignment of the underlying loans made by the Community to the members. The source of repayment for the loan to the Community is ultimately the income from various tribal enterprises. This income supports the Community's payment of monthly stipends to the members and these stipends in turn are used by the members to repay their loans to the Community. The principal tribal enterprise is the [ ] casino. A gas station and convenience store built in [ ] are adjacent to the casino. The Community also owns the nearby [ ] Motel with 122 rooms and swimming pool, a recreational vehicle park, and a six-story hotel with convention center that was built in [ ].

[1] [ ].

The bank has also made general consumer loans to members of the Community that are secured by an assignment of the members' monthly stipends that they receive from the Community. The bank may make further such loans although it is expected that no member will borrow from both the bank and from the Community loan fund described above at the same time. The source of repayment for the bank's loans to the members is the monthly stipends (currently $5,200) that Community members are allotted by the Community. Tribal enterprises, such as the casino, and not the bank's loan to the Community, support payment of these stipends by the Community. It is a requirement for receipt of the monthly stipend that the members live within a 10-mile radius of the Community's trust lands. Some members also receive wages from Community enterprises, though the bank has never asked for an assignment of wages to secure loans to members of the Community, and it is assumed for the purposes of this analysis that the members do not receive sufficient wages from which their loans and other obligations may be fully repaid.

Legal Analysis

The purpose of the lending limit is to protect the safety and soundness of national banks by preventing excessive loans to one person and to promote diversification of loans and equitable access to banking services. Generally, a national bank's total outstanding loans to one borrower may not exceed 15 percent of the bank's capital and surplus, plus an additional 10 percent of capital and surplus if the amount over the 15 percent general limit is fully secured by readily marketable collateral.[2] Also, loans to one borrower will be attributed to another person and both will be considered a borrower when, among other things, (1) the proceeds are used for the direct benefit of the other person, or (2) a common enterprise is deemed to exist between the persons.

The proceeds of a loan to a borrower will be deemed to be used for the direct benefit of another person and will be attributed to that other person when the proceeds, or assets purchased with such proceeds, are transferred to that other person, other than in a bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services.[3]

A common enterprise is deemed to exist, inter alia, "[w]hen the expected source of repayment for each loan . . . is the same for each borrower and neither borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid. An employer will not be treated as a source of repayment under this paragraph because of wages and

[2] 12 USC 84(a) and 12 CFR 32.3(a).

[3] 12 CFR 32.5(b).

salaries paid to an employee unless the standards of [the common control and substantial financial interdependence test][4] are met."[5]

1. Direct Benefit

The proceeds of the loan to the Community are used by the Community to make loans to members of the Community.[6] However, such members do not also borrow from the bank. Thus, while the direct benefit test requires that the loan to the Community be *attributed* to the members to whom the Community makes loans, those attributed loans are not *combined* with any other loans under the direct benefit test.[7]

There is no information in your letter regarding the transfer of proceeds of the loans to the members (or of assets purchased with such proceeds) from one member to another member or from the members to the Community. Accordingly, without further facts, there is nothing to support attribution of the loans to members to other members or to the Community.[8]

2. Common Enterprise

The expected source of repayment for the loan to the Community is the repayment of the Community's loans to the members that is dependent on the monthly stipends that are supported by income from tribal enterprises, principally the [ ] casino. The expected source of repayment for the current and future loans to the members of the Community is the monthly stipends that each member receives from the Community and that are derived from the same tribal enterprises. The expected source of repayment for the loan to the Community and the loans to the members is thus the same. Further, no borrower—neither the Community nor any member—has another source of income from which the borrower's loan, and the borrower's other obligations, can be fully repaid.

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[4]That test provides that a common enterprise is deemed to exist when borrowers are related through common control and there is substantial financial interdependence between or among the borrowers.

[5]12 CFR 32.5(c)(1).

[6]Since the proceeds of the loan to the Community do not fund the stipends that the Community pays to members, the payment of stipends does not cause the direct benefit test to require that the loan to the Community be attributed to members.

[7]If a member borrowed from both the bank and from the Community, the direct benefit test would require that the part of the bank's loan to the Community that the Community re-loaned to the member be combined with the bank's loan to the member. The transfer of proceeds by the Community to such members would not be excepted by the exception for bona fide arm's length transactions where proceeds are used to acquire property, goods, or services. It is an established OCC position that "borrowed funds that are re-loaned to a third party would be attributed to the third party under this test." 59 *Fed. Reg.* 6593, 6596 (February 11, 1994).

[8]I assume that the members may acquire property, goods or services from the Community or its enterprises and that the bank's loans to the members may support such transactions. Provided such transactions are bona fide arm's length transactions, they would not cause the direct benefit test to require the loans to the members to be attributed to the Community.

Accordingly, absent an exception, the loans would be combinable under the common source of repayment test—the members' loans with other members' loans[9] and the members' loans with the loan to the Community.

As noted above, an employer will not be treated as a common source of repayment because of wages and salaries paid to its employees, unless the employees control[10] the employer and there is substantial financial interdependence between them. This position is sometimes referred to as the "company town" exception since it was originally intended to facilitate the granting of credit to employees in such a town. A "company town" is a town in which residents are dependent on the economic support of a single firm for maintenance of retail stores, schools, hospitals, and housing.[11] Without the exception, it would be difficult for a local bank to serve effectively the credit needs of the town's residents. As noted above, one of the purposes of the lending limit is to promote equitable access to banking services.

The current case is very similar to the company town scenario in that all the members of the Community live in a single, small geographic location and are uniquely associated with, and dependent on, a single entity that is the community hub from a commercial and socioeconomic perspective. Thus, the need for equitable access to banking services is as important in the current factual circumstances as it is in the company town scenario. Further, there is a strong public interest in making available to Indian tribes and their members access to banking services, including

[9]Some OCC precedent, beginning with interpretations of prior versions of the lending limit regulation, has taken the position that the common source of repayment test hinges on whether the repayment capacity of one borrower is dependent upon the financial health of another borrower rather than whether repayment will be made from the same expected source. Under this view, absent an exception a loan to a member of the Community would only be combined under the common source of repayment test with the loan to the Community on which the member is dependent, not with a loan to another member, since no member is dependent on another member. However, other OCC precedent has held loans to be combinable under the common source of repayment test in circumstances in which one borrower was not financially dependent on another borrower, based on the commonality of the source of repayment. The current regulation on its face does not require dependence on another borrower but rather requires neither borrower to have another source of income to fully repay its loan and other obligations. In light of this regulatory clarity, the correct position under 12 CFR part 32 is that dependence on another borrower is not required under the common source of repayment test.

[10]I note that the Community is comprised only of its members and those members elect a governing council to run the affairs of the Community. Such a democratic system does not involve concerted action by the members and does not constitute "control" for the purposes of this provision.

[11]See *The American Heritage Dictionary of the English Language* (4th ed., 2000).

credit products.[12] Although in the current case, payments received by the members are principally stipends rather than wages and salaries, the so-called company town exception is available in this case because of the unique and compelling similarities between the employer-employee relationship in a company town and the relationship between the Community and its members here. Accordingly, the loans to the members need not be combined under the common source of repayment test with loans to other members or with the loan to the Community.

Please note that this letter responds only to the common enterprise lending limit issue raised in your letter. It does not address safety and soundness risks that may be posed by the loan to the Community or by loans to the Community members, individually or in the aggregate. Under 12 CFR 32.1(c)(4), the lending limit requires that loans made by national banks must be consistent with safe and sound banking practices.

Please also note that in reaching the foregoing conclusion, I have relied on the factual representations contained in your letter and in telephone conversations with OCC staff. The position set forth in this letter depends upon the accuracy and completeness of those representations and the facts set forth in this letter. Any change in circumstances could result in a different conclusion.

I trust the foregoing is responsive to your inquiry.

Jonathan Fink
Senior Attorney, Bank Activities and Structure

[12]An entire federal agency program—the Bureau of Indian Affairs' Loan Guaranty, Insurance, and Interest Subsidy Program, 25 CFR part 103—exists to encourage eligible borrowers to develop viable Indian businesses through conventional lender financing. The program helps borrowers secure conventional financing that might otherwise be unavailable. The OCC has long regarded access to banking services by Indian tribes and their members as an important public policy objective. For example, among other initiatives, the OCC hosts the Native American Banking Resource Directory at http://www.occ.treas.gov/cdd/nativeam.htm and has published "A Guide to Mortgage Lending in Indian Country" (July 1997) and "Providing Financial Services to Native Americans in Indian Country (July 1997). In addition, the OCC hosted a Native American Banking Forum in 2002 at which the OCC's First Senior Deputy Comptroller and Chief Counsel noted "that the presence of banks is crucial for any community's economic strength" and that "banks are developing a greater understanding that exploring and serving the financial needs of underserved populations fits in with their long-term self-interest." See http://www.occ.treas.gov/cdd/Williams101602.pdf.

980—December 24, 2003

12 USC 36

[Summary: Letter concludes that the installation of UPS drop boxes at nonbranch offices of a bank will not cause those offices to be considered branches under 12 USC 36, because they are owned by an independent third party and can be used by the general public for nonbanking transactions.]

Subject: UPS drop boxes at *[NB],* financial centers

Dear [ ]:

This is in your response to your request for confirmation that the installation of United Parcel Service (UPS) drop boxes at various nonbranch offices of *[NB, city, state]* (the bank), does not cause those offices to be considered branches, which would subject them to restrictions on branching set forth in 12 USC 36. Your inquiry was prompted by the OCC's request seeking additional information about the operation of drop boxes on the premises of the bank's financial centers into which deposit account applicants would place their applications, along with their initial deposits, for pick up and delivery to the bank's main office in *[state]*. The concern at the time was that the operation of these drop boxes could cause the financial centers to be considered to be branches of the bank.[1]

Since then, you advised us that the drop boxes are being replaced with UPS drop boxes. You seek OCC confirmation that, as operated, these drop boxes do not cause the financial centers to be considered branches. We understand that while bank customers still use these drop boxes to send the account-opening documentation and a check or checks representing the initial deposit to the bank's main office, the UPS drop boxes also are available for use by the general public. In this regard, you note that UPS lists the drop box sites at the bank's financial centers, along with all of its other drop box locations, on its UPS web site. In addition, the locations of the drop boxes also are available by dialing the UPS 800 number, which directs callers to nearby drop box locations, based on zip code or telephone number, along with last pick-up times. Moreover, the drop boxes

[1]Facilities of national banks that provide for the in-person receipt of deposits, paying of checks, or lending of money between the bank and a customer are considered to be branches. 12 USC 36(j); 12 CFR 5.30(d)(1). The Supreme Court has determined that bank-provided drop boxes, in which customers place deposits, require branch authorization, and the OCC branching regulation reflects this determination. *First National Bank in Plant City* v. *Dickinson,* 396 U.S. 122, 137–138 (1969) (stating that "at the time a customer delivers a sum of money . . . to . . . the stationary receptacle, the bank has for all purposes contemplated by Congress in [12 USC 36(j)] received a deposit"); 12 CFR 5.30(d)(1)(i). In contrast, while customers may fill out deposit account forms and give them to a bank at a bank office, this does not, standing alone, convert the facility into a branch. 12 CFR 7.4004(a).) We note also that the exception in section 36(j), adopted in 1996, for automated teller machines and remote service facilities applies only to automated facilities for receiving deposits or paying withdrawals. 12 CFR 7.4003.

at the financial centers are available to ship any items that UPS drop boxes normally handle to any location to which UPS normally delivers, including to other financial institutions. You further represent that UPS shipping supplies, such as envelopes and waybills, are provided at the drop boxes so that any person wishing to utilize the service may do so. Moreover, we understand that the drop boxes in no way indicate that they are available for use only by bank customers, are clearly marked with UPS logos, are not be customized in any way for the bank, and are of the same type and appearance as those placed by UPS in commercial office buildings and on street corners nationally.

You further represent that UPS, a nationwide delivery service that operates thousands of pick up locations, including drop boxes, throughout the country and which delivers to virtually everywhere in the United States and abroad, is an independent third party that is not owned, operated or controlled by the bank. You note that UPS employs and controls the persons who provide the services in question, that the bank and UPS do not share employees at the sites, and that only UPS employees, not bank employees, have access to the contents of the drop boxes. Moreover, you note that bank employees at no time handle the deposits; envelopes containing deposit account documentation and deposits are placed in the drop boxes directly by bank customers, not by bank employees.[2] Further, UPS determines the schedule by which it picks up, transports and delivers shipments.

You also represent that UPS acts as agent for the customers and all others using the drop boxes while the items are in the drop boxes or in transit, and that UPS does not act as agent for the bank. Accordingly, UPS assumes responsibility for items during transit, and for maintaining adequate insurance covering thefts, employee fidelity, and other transit losses, as well as for loss or dam-

[2]As we understand the facts, customers seeking to open deposit accounts with the bank may fill out application forms at these financial centers. Bank employees provide customers with information regarding bank products and assist customers with completion of account opening documentation. In addition to the application, account disclosures, and signature cards, bank employees provide customers seeking to open a deposit account a bank inner envelope and a preaddressed UPS Next Day Air Envelope (the UPS envelope). The customer is instructed to place the account opening documentation, which may include a check or checks for the initial deposit, in the bank's inner envelope, complete and retain the disclosure form on the bank's inner envelope, and place the bank's inner envelope in the UPS envelope. The customer is instructed to seal and place the UPS envelope in the UPS drop box. Once the UPS envelope is inside the UPS drop box, bank employees cannot retrieve it; UPS maintains the only keys to the drop box. A UPS employee removes the contents of the drop box on a daily basis based on UPS's own routing schedule and UPS delivers the UPS envelopes to the bank's main office in *[state]* and the other shipments to the stated addressees. The bank then processes the account application at its main office and either opens the account or returns the applicant's check by mail if the account is not opened.

age to third persons and property resulting from the installation and use of the drop boxes. Only upon physical delivery of the checks by UPS to the bank's main office, and processing by bank employees of the account opening documents, are the checks accepted for deposit.[3]

For the following reasons, we confirm that the presence of the UPS drop boxes, as you describe, at nonbranch offices of the bank does not cause those offices to be considered branches under 12 USC 36.

National banks are permitted to share space with other businesses under 12 USC 7.3001(a), subject to the requirements set forth in paragraph (c).[4] The bank has represented that its space sharing arrangement with UPS complies with each of these requirements. In this regard, the bank notes that the drop boxes are conspicuously identified as belonging to UPS and that no bank advertising suggests otherwise; that the arrangement between the bank and UPS does not constitute a joint venture or partnership under applicable law; that the arrangement is an arm's length relationship with no shared responsibilities or liabilities; that UPS, by contract, incurs liability for security issues unless any loss or damage is the result of negligence or wrong-doing by the bank; that the activities of UPS do not adversely affect the safety and soundness of the bank; and that the assets and records of UPS and the bank are segregated. According to the bank, while the lease agreement under which UPS places its drop box in bank facilities is rent-free, this is consistent with the UPS's customary and usual practice when it places a drop box on the premises of any business that requests placement of a drop box.

Moreover, as the facts are represented by the bank and described above, the arrangement complies with the factors set forth in 12 USC 7.1012(c)(2), which the OCC employs in determining whether a messenger service that transports items for deposit to a national bank should not be considered a branch of that bank. Section 7.1012(c)(1) provides that a messenger service is not considered a branch of a bank provided that it is established and operated by a third party. Section 7.1012(c)(2) provides that whether a messenger service is established by a third party is determined on a case-by-case basis and then provides a variety of factors that are considered in making that determination.[5]

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[3]The bank represents that customers are advised in writing prior to the use of the UPS service that (a) UPS, a third party delivery service, acts as agent of the customer rather than the bank, (b) that the bank is not responsible should the deposit be lost, stolen, damaged or delayed in delivery; and (c) the application and deposit are not considered to be received by the bank until received at the bank's main office. These disclosures are contained on a form attached to the outside of the bank's inner envelope on which the customer writes the date, the title of the account, a reference number that the bank has assigned to the account, the check number and amount, and the UPS tracking number. In addition, the form contains a box for the customer to check in order to acknowledge receipt of the disclosures. The customer tears off and retains one copy of this form and the other remains attached to the bank inner envelope.

[4]These requirements pertain to conspicuous identification of the businesses, that the arrangement does not constitute a joint venture or partnership, that the relationship between the entities is at arm's length, that security issues are resolved, that the activities of the other business do not adversely affect the safety and soundness of the bank, and that the assets and records of the parties are segregated. We note that UPS and the bank do not share any employees; consequently, the provisions of section 7.3001 that pertain to the sharing of employees are not applicable.

[5]12 CFR 7.1012(c)(2)(i)–(vi).

These factors are: A party other than the national bank owns or rents the messenger service and its facilities, and employs the persons who provide the service; the messenger service must retain the discretion to determine in its own business judgment which customers and geographic areas it serves;[6] the messenger service maintains ultimate responsibility for scheduling, movement, and routing; the messenger service does not operate under the name of the bank, and the bank and the messenger service do not advertise, or otherwise represent, that the bank itself is providing the service, although the bank may advertise that its customers may use one or more third-party messenger services to transact business with the bank; the messenger service assumes responsibility for the items during transit and for maintaining adequate insurance covering thefts, employee fidelity, and other in-transit losses; the messenger service must act as the agent for the customer when the items are in transit; and the bank must deem items intended for deposit to be deposited when credited to the customer's account at the bank's main office, branch office or other permissible nonbranch location.[7]

I conclude that based upon the bank's representations and the analysis set forth above, the placement of UPS drop boxes in the bank's nonbranch financial center offices does not cause those facilities to be considered branches of the bank and does not subject those offices to branching restrictions and requirements. I hope that this is responsive to your inquiry.

Eric Thompson
Director, Bank Activities and Structure

[6]Where the messenger service and the bank are under common ownership or control, the regulation sets forth an alternative factor—that the "the messenger service actually provides its services to the general public, including other depository institutions. . . ." *Id.* at 7.1012(c)(2)(ii)(B). We note that construing the placement and operation of the UPS drop boxes on bank premises as being subject to the control of the bank, this alternative requirement is satisfied. The drop boxes clearly are made available to the general public.

[7]We note that a national bank may defray all or part of the costs incurred by a customer in transporting items through a messenger service, but that payment of those costs may only cover expenses associated with each transaction involving the customer and the messenger service. The national bank may impose terms, conditions, and limitations that it deems appropriate with respect to the payment of such costs. 12 CFR 7.1012(c)(3).

981—August 14, 2003

[Summary: Letter states that a national bank may rely on the rating assigned to the uninsured portion of the bank's certificates of deposit to satisfy the debt rating requirement necessary to establish a financial subsidiary under Section 121 of the Gramm–Leach–Bliley Act. The certificates of deposit qualify as "eligible debt" for purposes of the requirement under Section 121 that any of the 50 largest insured banks must have at least one investment grade rated issue of debt outstanding in order for the bank to establish a financial subsidiary.]

Subject: [ ] (Bank) Request for Interpretive Letter on Financial Subsidiary Debt Rating Requirement

Dear [ ]:

This is in response to your request for confirmation that the bank may rely upon a rating from Standard and Poor's (S&P) on the uninsured portion of the bank's long-term certificates of deposit (CDs) for purposes of the debt rating requirement the bank must satisfy in order to establish a financial subsidiary engaged in certain financially related activities as principal, such as securities underwriting and dealing.[1] For the reasons discussed below, we conclude that the bank may use its investment grade rated CDs to meet this debt rating requirement.

Background

Under section 121 of the Gramm–Leach–Bliley Act,[2] a national bank is authorized to establish a financial subsidiary to engage in activities, not otherwise permissible for a national bank, that have been determined to be financial in nature provided certain specified conditions are met.[3] Where the financial subsidiary will be engaged in such activities as principal rather than solely as agent, a bank that is one of the 50 largest FDIC-insured banks must have at least one issue of outstanding eligible debt that is currently rated within the three highest investment grade categories by a nationally recognized statistical rating organization (debt rating requirement).[4]

Based upon its consolidated assets as of December 31, 2002, the bank is one of the 50 largest FDIC-insured banks. As a result, it must satisfy the debt rating requirement in order to acquire or establish a financial subsidiary that engages in financial in nature activities as principal, not otherwise permissible for a national bank, such as securities underwriting and dealing. At present, the

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[1]*See* 12 USC 24a(a)(3)(A)(i), 12 CFR 5.39 and discussion below.

[2]Public Law 106–102, 113 Stat. 1338.

[3]*See* 12 USC 24a.

[4]12 USC 24a(a)(3)(A)(i). A bank does not have to satisfy the debt rating requirement if its financial subsidiaries engage in newly authorized financial activities solely as agent and not as principal.

bank has not issued and does not have outstanding any issues of nondeposit debt.[5] The bank does, however, have outstanding long-term CDs that are rated investment grade. S&P has assigned a long-term Certificate of Deposit issue rating to the bank of "A–" [A minus].[6] This credit rating does not relate to the FDIC-insured portion of any CD issued by the bank. The rating category "A" (Strong) is the third highest of S&P's investment grade rating categories, and the addition of a plus (+) or minus (–) sign shows relative standing within a rating category. This rating applies to the uninsured portion of all the CDs that the bank issues that are long-term and in an initial amount of $100,000 or greater. S&P has advised the bank that the ratings criteria, definitions, and methodology employed by S&P in assigning a long-term CD rating are the same as those employed by S&P in assigning a rating to an issue of long-term nondeposit debt. The bank contends that its rated CDs satisfy the debt rating requirement because they are rated investment grade, and they qualify as eligible debt.

Discussion

To qualify as "eligible debt," the instrument must be "unsecured long-term debt that (A) is not supported by any form of credit enhancement, including a guarantee or standby letter of credit; and (B) is not held in whole or in any significant part by any affiliate, officer, director, principal shareholder, or employee of the bank or any other person acting on behalf of or with funds from the bank or any affiliate of the bank."[7] The OCC's financial subsidiary regulation defines the term "long-term debt" to mean "any debt obligation with an initial maturity of 360 days or more."[8]

Consistent with those definitions, the bank's Jumbo CDs are unsecured and long-term, with an initial maturity of one year or longer, and in an initial amount of $100,000 or greater. The CDs are not supported by any form of credit enhancement, including a guarantee or standby letter of credit.[9] And they are offered generally to the public and are not held in whole or in any significant part by any affiliate, officer, director, principal shareholder, or employee of the bank or any other person acting on behalf of or with funds from the bank or an affiliate of the bank.[10] The only remaining issue is whether they are "debt" of the bank for purposes of the debt-rating requirement.

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[5]According to the bank, this is due largely to the fact that the bank is a wholly owned subsidiary of [ ] (Holding Company), and the holding company issues all nondeposit debt for the company and its subsidiaries.

[6]The total outstanding amount of the bank's long-term jumbo CDs as reported in the call report for [ ] was $286,855,000.

[7]12 USC 24a(a)(3)(A)(i).

[8]12 CFR 5.39(d)(8).

[9]The rated portion of the CD is not covered by FDIC insurance, and S&P does not take the existence of FDIC insurance into account in assigning its rating.

[10]The bank has advised the OCC that the amount of CDs held by affiliates represents approximately [ ] percent of the total long-term jumbo CDs issued by the bank.

The term "debt" is not defined in the statute or the OCC's financial subsidiary regulation.[11] As a general rule of statutory construction, when the words of a statute are not defined, they are given their plain or ordinary meaning.[12]

The term "debt" ordinarily refers to an obligation owed to another person. *Webster's Dictionary* defines "debt" as "something owed, as money, goods or services" and as "an obligation or liability to pay or render something to another."[13] Similarly, *Ballentine's Law Dictionary* defines debt as "an unconditional and legally enforceable obligation for the payment of money; it involves the relationship of debtor and creditor, or of borrower and lender."[14]

A certificate of deposit falls squarely within those definitions. *Webster's* defines a certificate of deposit as a "document evidencing ownership or debt," and *Ballentine's* defines a certificate of deposit as a bank's ". . . promise to pay the depositor, whereby the relation of debtor and creditor between the bank and the depositor is created."[15] Thus, like the ordinary meaning of "debt," a CD is commonly understood as an obligation owed to another person.

That CDs are "debt" also is evident from their accounting treatment. For example, certificates of deposit, like other debt obligations, are reported as liabilities on the issuing bank's balance sheet.[16] Similarly, a bank that issues a certificate of deposit is required to report it as a liability of that bank in the bank's Consolidated Reports of Condition and Income (call reports). Likewise, a certificate of deposit purchased by a bank and due from another bank is listed as an asset of the purchasing bank in the balance sheet portion of the call report. The OCC has characterized the uninsured portion of a certificate of deposit that a bank purchases from an issuing bank as an "unsecured debt of the issuing bank."[17]

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[11] *See* 12 USC 24a and 12 CFR 5.39(d)(8). The OCC declined to define the term "debt" in its financial subsidiary regulation, reasoning, "in cases where there is a question about whether an obligation qualifies as debt, the issue is better addressed on a case-by-case basis." 65 *Fed. Reg.* 12905 (2000).

[12] *See generally*, Singer, *Statutes and Statutory Construction* ¶ 46:01 (6th ed. 2000).

[13] *Webster's II New Riverside University Dictionary* at 328 (1984).

[14] *Ballentine's Law Dictionary* 311 (3rd ed. 1969). *Black's Law Dictionary* defines debt as "a sum of money due by certain and express agreement." *Black's Law Dictionary* 210 (5th ed. 1983).

[15] *Webster's supra* at 223 and *Ballentine's Law Dictionary, supra* at 187. Similarly, *Black's Law Dictionary* defines a CD as a "written acknowledgement by a bank . . .of a deposit with a promise to pay to depositor." *Black's Law Dictionary, supra* at 116.

[16] Under generally accepted accounting principles (GAAP), CDs, like other debt instruments, are treated as liabilities of the issuing bank. Although GAAP does not specifically define "debt," it defines "liabilities" as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." CDs and debt obligations both meet that definition of liabilities. *See* United States/FASB FASB Original Pronouncements (as of 03/15/2003): Statements of Financial Accounting Concepts, CON 6: Elements of Financial Statements—Definitions of Elements.

[17] *See* OCC 1992 *Examiner's Guide to Investment Products and Practices.*

Defining "debt" to include certificates of deposit also is consistent with the purpose underlying the debt rating requirement. By imposing the debt rating requirement on large banks, Congress sought to ensure that the institutions were considered creditworthy by the financial markets. That purpose can be achieved with any highly rated debt issuance, including the bank's certificates of deposit. In fact, S&P has advised the bank that it uses the same standards in rating certificates of deposit that it uses to rate nondeposit debt issuances.

Moreover, it is clear from the legislative history that Congress viewed deposits, which would include certificates of deposit, as debt obligations of the bank. For example, prior versions of GLBA had required that large banks have at least one outstanding share of subordinated debt rated within the two highest investment grade categories.[18] The term "subordinated debt" was defined, in part, as unsecured debt that "is subordinated as to payment of principal and interest to *all other indebtedness of the bank, including deposits*. . . ."[19] This subordinated debt requirement was replaced in the final version of GLBA with the eligible debt requirement. Replacing the term "subordinated debt" with the broader and more inclusive term "eligible debt" demonstrates that Congress did not intend to limit the type of debt required to nondeposit debt.[20]

Courts also have recognized that deposits, including certificates of deposit, are debt obligations of the issuing bank. Various courts have described certificates of deposit as "debt instruments," "long-term debt obligations," and "evidence of indebtedness."[21] And the relationship of a bank to a depositor has been described as that of "debtor and creditor, founded upon contract."[22]

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[18]*See* Section 121, Title I, Subtitle C of Mark-up Draft of S. 900 and H.R. 10 as Proposed by Chairman Gramm, Chairman Leach, and Chairman Bliley, October 9, 1999 ("Chairmen's Mark").

[19]*See* Chairmen's Mark, *supra* (emphasis added).

[20]Another indication that Congress did not intend to limit the type of debt required to satisfy the debt rating requirement is evidenced by the use of the term "debt," instead of the equally common but less inclusive term "debt securities." Had Congress used the term "debt securities" in the debt rating requirement, CDs and other bank deposits may not have qualified since CDs are generally not considered securities for purposes of federal banking and securities laws. *See Marine Bank* v. *Weaver*, 455 U.S. 551 (1982) (certificates of deposit are not securities for purposes of federal securities laws because of the "extensive protections the federal regulatory scheme affords depositors.") *But see*, *Holloway* v. *Peat Marwick*, 879 F.2d 772, 777 (10th Cir. 1989) (instruments similar to certificates of deposit, but not insured by the FDIC, were securities under the federal securities laws because they were "essentially debt instruments, representing a promise by the issuing entity to repay the principal amount, plus accrued interest at a specified rate, within a specified time period or on demand").

[21]*See, e.g., Holloway* v. *Peat Marwick*, *supra* at 777; *Associates in Adolescent Psychiatry, et al.* v. *Home Life Insurance Company of New York, et al.*, 729 F. Supp. 1162 (N.D. Ill. 1989); and *MacKethan* v. *Peat, Marwick, Mitchell & Co.*, 439 F. Supp. 1090, 1094 (E.D. Va. 1977).

[22]*Bank of Marin* v. *England,* 385 U.S. 99, 101 (1966).

Conclusion

The bank may rely on its investment grade rated CDs to meet the debt rating requirement for establishing financial subsidiaries. The CD's qualify as "eligible debt" as defined by statute. In addition, they have the required investment grade issue rating from a nationally recognized statistical rating organization. This conclusion is not intended, and should not be read, as an approval of a particular financial subsidiary of the bank, however. The bank must comply with the approval requirements under 12 CFR 5.39 before establishing or acquiring an interest in a financial subsidiary.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

982—September 29, 2003

12 USC 1972

[Summary: Letter states that a national bank may condition the offering of its securities underwriting services on the use of the bank's letter of credit to secure the bond issue.]

Re: [ ] (Bank) (Consumer Case Number [ ])

Dear [ ]:

Thank you for your inquiry to the Office of the Comptroller of the Currency's (OCC's) Customer Assistance Group (CAG) concerning a proposal by a national bank, that you were concerned may involve tying under Section 106 of the Bank Holding Company Act, 12 USC 1972. As you may recall, the CAG representative forwarded your inquiry to the OCC's Law Department for resolution. In the meantime, the OCC and the Board of Governors of the Federal Reserve System ("FRB") have focused considerable attention on tying matters. The OCC and FRB recently conducted a joint review of tying practices at large banking organizations. Various other regulatory reviews also are on-going.[1] We provide the following response based on the information you submitted and our subsequent review of the matter involving the Bank and [ ] School.

You indicated you are an investment banker from [ ] Inc. ("consumer") and that you were involved in a tax-exempt bond underwriting for a private school in [state] in the spring of 2002. The school requested proposals for underwriting services and letter of credit facilities. The bank submitted a proposal. Specifically, the bank's letter stated: "[Bank]'s proposal to serve as underwriter requires that the [school] utilize a [ ] letter of credit to secure its bond issue." We understand that neither the bank nor its securities affiliate received any of the proposed underwriting or letter of credit business. You inquired whether the practice described in the bank's letter was a violation of the federal tying statute.

The federal tying statute, 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;

[1]For example, the National Association of Securities Dealers, Inc., is conducting an investigation focusing on broker-dealers affiliated with commercial banks and seeking to determine whether tying of investment banking services and commercial credit has occurred in possible violation of their rules. Additionally, the General Accounting Office expects to issue a report concerning tying practices by banks in October 2003.

Section 1972 generally prohibits a bank 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 FRB may permit exceptions to the anti-tying prohibitions and has interpretive authority over section 1972.[2]

Section 1972 contains an explicit exception (the statutory "traditional bank product exception") that permits a bank to tie any product or service to a loan, discount, deposit, or trust service offered by that bank. This exception applies only if the "tied product" is a traditional bank product. The availability of the exception does not depend on the type of "tying product" involved, however. Section 1972 is premised on the notion that the "tying product," also called the "desired product," is the product the customer really seeks. For example, the FRB has explained that a bank could condition the use of its messenger service on a customer's maintaining a deposit account at the bank.[3] However, a bank could not condition maintaining a deposit account on a customer using the bank's messenger service. For this reason, a tie is permissible in one direction but not in the other direction. Thus, a bank might be engaging in a prohibited tying practice if the bank would not extend credit to a customer unless the customer also engaged the bank for certain products not within the scope of a traditional bank product, such as securities underwriting.[4] This example illustrates a tying arrangement outside the traditional bank product exception because the "tied product" is not a traditional bank product.

The information here indicates the bank offered a nontraditional product, i.e., the securities underwriting, conditioned on the use of the traditional bank product, i.e., the letter of credit. Under the statutory exception, traditional bank products include "loans." National banks have long-provided "letters of credit" as part of their expressly authorized lending function under 12 USC 24

[2]Recently, the FRB issued a proposed interpretation and supervisory guidance providing comprehensive discussion on many aspects of the federal tying restrictions applicable to banks, including examples of conduct, actions, and arrangements by banks that are prohibited and permissible under section 1972. *See* Board of Governors of the Federal Reserve System, *Anti-Tying Restrictions of Section 106 of the Bank Holding Company Act Amendments of 1970* (August 25, 2003) ("Fed Tying Release"). The FRB's release requests public comments by September 30, 2003.

[3]62 *Fed. Reg.* 9290, 9314 (1997) (FRB amendments to its tying regulation).

[4]*See, e.g.,* Fed Tying Release, at 13. The FRB has indicated for purposes of section 1972 that a "nonbanking product" or "nontraditional" banking product is anything other than a "loan, discount, deposit, or trust service." *See, e.g.,* 12 USC 1972(1)(A); Letter from William W. Wiles, Secretary of the Board, FRB (September 19, 1997); 60 *Fed. Reg.* 20186, 20188 (1995).

(Seventh).[5] The direct advance of funds to a borrower through a letter of credit is well recognized in the industry as a traditional bank product.[6]

Accordingly, for this particular situation, based on the bank's letter, the OCC's review, the language of the statute, and the FRB's precedent, the arrangement described was not a prohibited tying arrangement because it was within the statutory traditional bank product exception of 12 USC 1972(1).

If you have any questions regarding this letter, please contact Suzette H. Greco, Special Counsel, Securities and Corporate Practices Division, at (202) 874–5210.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[5]*See American Insurance Ass'n* v. *Clarke,* 656 F. Supp. 404 (D.D.C. 1987), *aff'd*, 865 F.2d 278 (D.C. Cir. 1988); R. Trimble, "The Implied Power of National Banks to Issue Letters of Credit and Accept Bills," 58 Yale L.J. 713 (1949).

[6]In its recent release, the FRB specifically recognizes letters of credit as a product within the scope of a defined traditional bank product. *See* Fed Tying Release, at 17.

983—October 24, 2003

12 USC 2901

[Summary: Letter opines that a bank's proposed investment in a fund with the purpose of providing employment for low- and moderate-income individuals would be a qualified investment under the Community Reinvestment Act regulations.]

Subject: *["The Fund"]*

Dear [ ]:

This letter responds to your inquiry whether a proposed investment by *[bank]* would be considered a qualified investment under the Community Reinvestment Act (CRA). You also asked whether the investment would be considered a complex and innovative investment of the type not routinely provided by private investors that is responsive to community development needs. For the reasons discussed below, it appears that the proposed investment would be considered a qualified investment for CRA purposes. Further, the bank should receive qualitative consideration for its investment because of the bank's involvement in helping to structure the new investment fund.

Description of the Bank's Proposed Investment

The bank proposes to invest in *[the fund].* The managing member of the fund will be *[the intermediary]*, a nonprofit financial intermediary with a workforce development mission, the majority of whose board appointments are controlled jointly by the *[AA]* and the *[BB].* The fund's sole activity will be to invest in an operating company, *[operating company].*

The operating company will be structured as a limited liability company whose managing member will be a wholly owned nonprofit subsidiary of the *[CDC]* of *[city, state],* a community development corporation (CDC). The operating company will employ individuals, a majority of whom are low- and moderate-income, and who are expected to qualify for various federal employment tax credits, including the Work Opportunity Credit, the Welfare-to-Work Credit, and the Renewal Community Employment Credit. These operating company employees will be assigned to provide labor hours at *[the CDC]* and other *[state]*-area institutions on a temporary and permanent basis under contract to such institutions. Employees will be hired to perform various types of work, including clerical, retail, security, and building maintenance. During the term of the bank's proposed investment, the operating company, which will be a start-up company, is projected to have less than $11.5 million in annual receipts (the current Small Business Administration definition of a small business in the Employee Leasing Services category).

The bank's investment will finance the employment of the operating company's employees and the provision of ancillary services to facilitate employees' continued employment, such as job training, medical insurance, and employee assistance programs (e.g., counseling and referrals intended to enable employees to overcome job-threatening obstacles).

The bank has invested staff time and substantial funds in analyzing and structuring this investment. The bank also asserts that this investment is the first of its kind in the country. The bank's financial return on its investment is expected to come primarily in the form of tax benefits from the federal employment tax credits mentioned above. Further, the proposed investment will benefit the bank's assessment area, which includes *[city, state]*.

Discussion

Under the CRA regulations, a "qualified investment" is "a lawful investment, deposit, membership share, or grant that has as its primary purpose community development."[1] "Community development" is defined to include:

- Community services targeted to low- or moderate-income individuals; or
- Activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's (SBA's) Development Company or Small Business Investment Company (SBIC) programs (13 CFR 121.301) or have gross annual revenues of $1 million or less.[2]

Through the "Interagency Questions and Answers Regarding Community Reinvestments"[3] (Qs & As), the agencies have provided additional guidance about the types of investments that are considered qualified investments. Among the Qs & As relevant to this proposed investment is __.12(h)(3) & 563e.12(i)(3)–1. This Q & A states, in pertinent part, that an investment intended to promote economic development by financing small businesses is a qualified investment if it meets both a size test and a purpose test. The investment meets the size test if it will finance entities that either meet the size eligibility standards of the SBA's Development Company or SBIC programs or have gross annual revenues of $1 million or less. To meet the purpose test, the activity must promote economic development. An investment is considered to promote economic development if it supports permanent job creation, retention, and/or improvement for persons who are currently low-or moderate-income, or supports permanent job creation retention, and/or improvement either in low- or moderate-income geographies or in areas targeted for redevelopment.

In this case, the bank will invest in the fund. The bank's investment will help to finance the operating company. The operating company is projected to meet the size requirements referenced above during the term of the bank's investment. In addition, the objective of the operating company is to provide employment to low- and moderate-income individuals (insofar as they qualify

[1] 12 CFR 25.12(s).

[2] 12 CFR 25.12(h)(2)–(3).

[3] 66 *Fed. Reg.* 36,620 (July 12, 2001).

for the Work Opportunity Credit (26 USC 51) and/or the Welfare-to-Work Credit (26 USC 51A)) and individuals residing in the federally designated *[state]* Renewal Community (who are eligible for the Renewal Community[4] Employment Credit (26 USC 1400H)). It appears, therefore, that the bank's investment will promote economic development by financing a small business, within the meaning of the CRA regulation.

In addition, Q & A __.12(s) & 563e.12(r)–4 states that an example of a qualified investment is an investment in an organization supporting activities essential to the capacity of low- and moderate-income individuals or geographies to utilize credit or to sustain economic development, such as, for example, job training programs that enable people to work. In addition to providing employment to low- and moderate-income individuals, the operating company will provide job training and other employee-assistance programs to its employees. The bank's investment in the fund will help the operating company fund such training and programs, which may be considered community services targeted to low- and moderate-income individuals. This also leads to a conclusion that the bank's investment would be a qualified investment under the CRA regulation.

A bank may also receive "qualitative" consideration for certain qualified investments if such investments are innovative or complex, they are responsive to credit and community development needs, and private investors do not routinely provide them. In this case, in order to be designated a Renewal Community, unemployment in the *[state]* area was at least one and one-half times higher than the national average. In addition, according to the information you provided, the CDC has identified job creation and workforce development as an area need because relatively few private sources are available to fund the employment of people with limited job opportunities and experience. *[The intermediary],* the *[AA],* and *[BB]* have worked together to structure this investment, and the bank has been assisting them with their efforts. The bank's investment appears to be responsive to the community development needs of the area. Because it appears to be the first fund of its type, it also is innovative and has not been routinely provided by private investors. Further, because of the bank's involvement with the structuring of the investment, the investment by the bank may be considered complex.

I trust this letter responds to your inquiry. If you have further questions, please contact Margaret Hesse, an attorney on my staff, or me at (202) 874–5750.

Michael S. Bylsma
Director, Community and Consumer Law Division

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[4]A community that is eligible for designation as a Renewal Community must be an area of pervasive poverty, unemployment, and general distress. At least 70 percent of the households living in the area must have incomes below 80 percent of the median income of households within the jurisdiction of the local government and the unemployment rate must be at least one and one-half times the national unemployment rate. For further information about Renewal Community requirements, see 26 USC 1400E.

984—December 17, 2003

12 USC 2901

[Summary: Letter opines that a bank's investment in connection with the New Markets Tax Credit program in a "Community Development Entity" (CDE), or a loan by a bank CDE to a "Qualified Active Low-Income Community Business" or another CDE, would received consideration as a qualified investment or a community development loan, respectively, when the institution's Community Reinvestment Act performance is evaluated.]

Subject: New Markets Tax Credits

Dear **[ ]**:

This letter responds to your inquiry whether a financial institution's investment in connection with the New Markets Tax Credit (NMTC) Program in a "Community Development Entity" (CDE), or a loan by a financial institution CDE to a "Qualified Active Low-Income Community Business" (QALICBs) or another CDE, would receive consideration as a qualified investment or a community development loan, respectively, when the institution's Community Reinvestment Act (CRA) performance is evaluated. We conclude that such investments and loans would be favorably considered under the CRA.

New Markets Tax Credit Program

The NMTC Program ("program") was a part of the Community Renewal Tax Relief Act of 2000.[1] The program was expected to stimulate investments that, in turn, would facilitate economic and community development in distressed communities.[2]

The program created a tax credit for taxpayers' "Qualified Equity Investments" (QEIs) in CDEs.[3] A CDE is a domestic corporation or partnership that is an intermediary vehicle for the provision of loans, investments, or financial counseling in "Low-Income Communities" (LICs).[4] CDEs must demonstrate that they (1) have a primary mission of serving, or providing investment capital for, LICs or low-income persons and (2) are accountable to residents of the LICs that they serve. CDEs are required to invest "substantially all" (generally 85 percent) of the proceeds of the QEIs

[1]H.R. 5662, introduced on December 14, 2000. Section 121(a) of Subtitle C of Title I of H.R. 5662 was enacted by section 1(a)(7) of the Consolidated Appropriations Act of 2001, Pub. L. 106-554 (Dec. 21, 2000).

[2]*See, e.g.,* Guidance, New Markets Tax Credit Program, 66 *Fed. Reg.* 21,846 (May 1, 2001).

[3]See 26 USC 45D. Over a seven-year period, an investor may claim a tax credit of 39 percent (30 percent in present value terms) of the amount of its QEI.

[4]LICs are census tracts with a poverty rate of at least 20 percent, or census tracts where the median family income is below 80 percent of the area median family income.

into LICs, including loans or investments in QALICBs.[5] In addition to investments in QALICBs, other "Qualified Low-Income Community Investments" (QLICIs) for CDEs are equity investments in, or to, another CDE; the purchase of a QLICI loan from another CDE; and financial counseling and other services to businesses located in, or residents of, LICs.

Community Development Financial Institutions and Specialized Small Business Investment Companies are automatically eligible to be designated as CDEs, but must complete an abbreviated application. Insured depository institutions with a primary mission of serving LICs or low-income persons, and with accountability to the LIC,[6] also may be designated as CDEs.

Community Reinvestment Act

Community development loans and qualified investments are important considerations in financial institutions' CRA performance evaluations. For larger banks, which are evaluated under the lending, investment and service tests, examiners routinely evaluate both community development loans and qualified investments. For smaller institutions, community development loans are routinely included when determining an institution's loan-to-deposit ratio, while qualified investments that are lending-related are considered along with an institution's loans. In addition, examiners will consider a small institution's other qualified investments if a small institution wishes to be considered for an "Outstanding" rating. Along with community development services, community development loans and qualified investments comprise the basis for the CRA performance evaluation for wholesale and limited purpose institutions that are evaluated under the community development test. Finally, institutions that are evaluated under an approved strategic plan may include community development loans and qualified investments in their measurable goals.

A "community development loan":

- has a primary purpose of community development; and,

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[5]In order to qualify as a QALICB, and therefore be eligible to receive CDE investments, a business must meet the following criteria:

At least 50 percent of the total gross income is from the active conduct of a qualified business in LICs;

At least 40 percent of the use of the tangible property of the business is located in LICs;

At least 40 percent of the services provided by the business' employees are performed in LICs;

Less the 5 percent of the average of the aggregate unadjusted bases of the property is attributable to collectibles (e.g., art and antiques), other than those held for sale in the ordinary course of business (i.e., inventory); and

Less than 5 percent of the average of the aggregate unadjusted bases of the property is attributable to nonqualified financial property (e.g., debt instruments with a term in excess of 18 months).

(The gross income test is deemed to be met if *either* the tangible property *or* the services test is at 50 percent or higher.)

[6]"Accountability" to the LIC may be demonstrated, for example, through representation by residents of the LIC on a governing board or advisory board of a corporate CDE.

- except in the case of wholesale or limited purpose banks,
  - has not been reported or collected by the institution or an affiliate for consideration in the institution's assessment as a home mortgage, small business, small farm, or consumer loan, unless it is a multifamily dwelling loan; and
  - benefits the institution's assessment area(s) or a broader statewide or regional area that includes its assessment area(s).[7]

A "qualified investment" is a "lawful investment, deposit, membership share, or grant that has as its primary purpose community development."[8]

"Community development" means:

1) Affordable housing (including multifamily rental housing) for low- or moderate-income individuals;
2) Community services targeted to low- or moderate-income individuals;
3) Activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's development company or small business investment company programs (13 CFR 121.301) or have gross annual revenues of $1 million or less; or
4) Activities that revitalize or stabilize low- or moderate-income geographies.[9]

Discussion

Would a financial institution's investment in a CDE receive consideration as a qualified investment during the institution's CRA evaluation?

An institution's equity investment in a CDE would receive consideration as a qualified investment if the investment benefits the institution's assessment areas or a broader statewide or regional area that includes its assessment areas. Such investments may be considered to have a community

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[7]12 CFR 25.12(i).

[8]12 CFR 25.12(s).

[9]12 CFR 25.12(h). Low- or moderate-income individuals have income that is less than 80 percent of the area median income. Low- or moderate-income geographies have a median family income that is less than 80 percent of the area median income.

development purpose under two prongs of the "community development" definition. First, to the extent that the CDE loans or invests in small businesses or farms, the qualified investment in the CDE promotes economic development by financing small businesses or farms. Second, because the primary mission of the CDE is to serve LICs, the loans and investments made by the CDE generally would help to revitalize or stabilize low- or moderate-income geographies.

Would a loan by a financial institution CDE to a QALICB or to another CDE receive consideration as a community development loan?

As long as a loan by a financial institution CDE to a QALICB or to another CDE has not been reported or collected by the institution or an affiliate for consideration in the institution's assessment area as a home mortgage, small business, small farm, or consumer loan (unless it is a multifamily dwelling loan), the loan would receive consideration as a community development loan.[10] Loans under $1 million to a QALICB or CDE by a retail institution would be reported as small business loans. However, larger loans would be considered community development loans because the loans have a primary purpose of community development, as discussed above.[11] For wholesale and limited purpose institutions, which are not evaluated on their small business lending, loans of any amount to a QALICB or CDE would be considered community development loans.

I trust this letter responds to your inquiry. I have shared this response with my colleagues at the other bank and thrift regulatory agencies, and they concur with this analysis. If you have further questions, please contact me at (202) 874–5750.

Michael S. Bylsma
Director, Community and Consumer Law Division

[10]Of course, for retail institutions, the loan would also need to benefit the institution's assessment areas or a broader statewide or regional area that includes its assessment areas.

[11]The analysis whether a loan by any retail institution to a CDE would be a community development loan would be the same—if the loan is not reported or collected as a home mortgage, small business, small farm or consumer loan (unless it is a multifamily dwelling loan), it would receive consideration as a community development loan.

985—January 14, 2004

12 CFR 5.36(e)

[Summary: Letter concludes that (1) the activities of a mortgage reinsurance company are substantively the same as those of a group mortgage reinsurance facility previously authorized by the OCC; and that (2) a national bank seeking to make a noncontrolling investment, directly or indirectly through an operating subsidiary, in the mortgage reinsurance company, may use the notice procedure available under the OCC's regulations at 12 CFR 5.36(e), if the bank otherwise qualifies under the criteria of that section.]

Subject: Proposed Group Mortgage Reinsurance Program

Dear [ ]:

This responds to your letter dated October 16, 2003, requesting the OCC's confirmation that a national bank's noncontrolling investment, made directly or indirectly through an operating subsidiary, in *[the reinsurer],* would qualify for the notice process in 12 CFR 5.36(e) because the activity of the reinsurer is substantively the same as that of a group mortgage reinsurance facility previously authorized by the OCC. The reinsurer is an association captive insurance company that will provide mortgage reinsurance on the loans of its participating financial institutions ("participating banks") and their affiliates and subsidiaries.

As explained below, we conclude that the activities of the reinsurer are substantively the same as those of a group mortgage reinsurance facility previously authorized by the OCC. Accordingly, a national bank seeking to make a non-controlling investment, directly or indirectly through an operating subsidiary, in the reinsurer, may use the notice procedure available under the OCC's regulations at 12 CFR 5.36(e), if the bank otherwise qualifies under the criteria of that section.

I. Background

The reinsurer was organized under the sponsorship of the *[ABC]* as an association captive insurance company[1] pursuant to Vermont's captive insurance law (Title 8 of the Vermont Statutes Annotated, Chapter 141). The Vermont Commissioner of Banking, Insurance, Securities and Health Care Administration (the "Vermont Commissioner") approved the *[ABC]'s* application to organize the reinsurer and granted it a certificate of authority to conduct business on *[date]*.

[1]Captive insurers insure or reinsure risks related to the business of their owner(s) and are subject to special insurance regulations. Association captives are a type of captive insurer, all of whose participants or owners are also members of a sponsoring industry association or similar group (in this case, the *[ABC]),* and which insures or reinsures only risks relating to its members.

Pursuant to the reinsurer's business plan filed with the Vermont Commissioner, ownership of the reinsurer's common stock is limited to member financial institutions of the *[ABC]* and their subsidiaries and affiliates. Participating banks are not liable for the reinsurer's reinsurance obligations or other debts and liabilities.[2] The reinsurer's authorized activities consist solely of reinsuring the mortgage insurance coverage[3] issued by nonaffiliated third-party mortgage insurers with respect to loans originated, purchased or serviced by the participating banks and their subsidiaries and affiliates. Any material change in the reinsurer's business plan, including the writing of any direct insurance or any other kind of reinsurance, requires the prior approval of the Vermont Commissioner.

As a licensed Vermont captive insurance company, the reinsurer will be subject to ongoing supervision and regulation by the Vermont Commissioner, and its operations will be limited to those specified in its certificate of authority from the Vermont Commissioner (mortgage reinsurance). Any material change in the reinsurer's business plan, including the writing of any direct insurance or any other kind of reinsurance, requires the prior approval of the Vermont Commissioner. In return for accepting the limited credit risk associated with the program, the reinsurer will receive reinsurance premiums.

The reinsurer has entered into a reinsurance agreement with *[Co.],* a *[state]* monoline mortgage insurance company, to assume (reinsure) a portion of *[Co.]'s* risk on mortgage insurance it provides on residential mortgage loans originated, purchased, or serviced by the participating banks, or their affiliates or subsidiaries. The participating banks' credit underwriting analysis and decision-making in connection with insured mortgage loans will not be delegated to *[Co.],* or any other party. *[Co.]* will perform its own independent insurance underwriting evaluation of loans submitted for coverage by a particular participating bank (other than participating banks approved by *[Co.]* for delegated underwriting[4]) and will accept for mortgage insurance only those loans that meet its underwriting criteria. You represent in your letter that it is expected that *[Co.]'s* un-

[2]The reinsurer is organized as a Vermont corporation. Under Vermont law, the shareholders of a corporation are not personally liable for the acts and debts of the corporation. *See* 11A V.S.A. § 6.22.

[3]Mortgage insurance protects an investor holding a mortgage loan against the risk of default by the mortgagor. Lenders generally require that borrowers obtain mortgage insurance on low down payment loans (generally loans having a down payment of less than 20 percent or a loan-to-value ratio in excess of 80 percent). Mortgage insurance serves an important function by assisting low and moderate-income families to become homeowners. Mortgage insurance also has expanded the secondary market for low down payment mortgages and the funding available for these loans. *See* Interpretive Letter No. 828 (citing Mortgage Insurance Companies of America 1995–1996 Fact Book).

[4]*[Co.]* may approve delegated underwriting authority for certain participating banks. A lender with delegated underwriting authority has the ability to bind mortgage insurance coverage for a loan that it approves utilizing *[Co.]*-approved underwriting criteria. *[Co.]* periodically reviews that lender's exercise of its delegated authority to insure that its credit underwriting criteria are being properly and consistently applied. Generally, lenders approved for delegated underwriting are those that generate a significant loan volume and have exhibited a proven favorable track record in the performance of their insured loan portfolios.

derwriting criteria will be applied by the participating bank as a supplement to their own particular organization's underwriting criteria, and will thus ensure homogeneity among the participating banks in the standards for origination and approval of reinsured loans.

II. The Reinsurer's Activities are Substantively the Same as Activities Previously Approved by the OCC

A. Reinsurer's Activities are Substantively the Same as Previously Approved Activities

Pursuant to OCC regulations at 12 CFR 5.36(e), well-managed, well-capitalized national banks may make a noncontrolling investment directly, or indirectly though an operating subsidiary, in an enterprise that engages in certain pre-approved activities or activities that are "substantively the same" as activities previously approved in published OCC precedent. The pre-approved activities, which are listed in 12 CFR 5.34(e)(5)(v), include "reinsuring mortgage insurance on loans originated, purchased, or serviced by the bank, its subsidiaries, or its affiliates. . . ."[5] The activities of the reinsurer, however, involve reinsuring mortgage insurance on the loans of unaffiliated financial institutions. In this respect, the reinsurer's activities are substantively the same as activities previously approved by the OCC. Specifically, the reinsurer's activities are substantively similar to the reciprocal mortgage reinsurance exchange (the "exchange") activities the OCC approved as being part of, or incidental to, the business of banking, in Interpretive Letter No. 828 (April 6, 1998) ("IL 828").[6]

In IL 828 the OCC authorized national banks to participate in a reciprocal mortgage reinsurance exchange that provided for the reinsurance of mortgage insurance on loans originated or purchased by participating lenders.[7] Participants in the exchange used the exchange arrangement as a means to reinsure their own mortgages. Similarly, participating banks will use the reinsurance arrangement as a means of reinsuring their own mortgages. In both situations, the risks assumed by the banks are essentially the same risks associated with underwriting mortgage loans. The analysis of the permissibility of the exchange participants' activities described in IL 828 applies equally to the activities of the participating banks in this case, and supports the conclusion that participation in the reinsurer's program is a permissible activity.

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

[6] The exchange described in IL 828 differs from the reinsurer in that the exchange is not a separate legal entity, but rather, exists as a relationship among the participating lenders that is established through agreements. The reinsurer, on the other hand, is a separate incorporated legal entity. The reinsurance activities of the exchange and reinsurer, however, are substantively the same.

[7] Like the reinsurer in this case, the exchange was a Vermont group captive insurer open to participation by nonaffiliated financial institutions; and like the reinsurer, the exchange provided economies of scale to small to mid-size banks which would otherwise have been unable to maintain a captive mortgage reinsurance facility of their own.

B. Application of Section 302 of the Gramm–Leach–Bliley Act

Under Section 302 of the Gramm–Leach–Bliley Act (GLBA), national banks and their subsidiaries may not provide insurance products as principal, except for "authorized products." The term "authorized products" is defined to include any product that the OCC had determined in writing, as of January 1, 1999, that national banks may provide as principal, or that national banks were in fact lawfully providing as principal, provided that, as of such date, no court had rendered a final judgment overturning such determination. Thus, Section 302 of the GLBA preserves the authority of national banks and their subsidiaries to provide an insurance product as principal so long as the product was authorized by the OCC on or before January 1, 1999.

The participating banks' mortgage reinsurance activities constitute authorized products. The OCC authorized national banks and their subsidiaries to reinsure mortgage insurance prior to January 1, 1999.[8] Further, in IL 828, issued on April 6, 1998, the OCC determined that the authority to reinsure mortgage insurance included national banks' participation in the exchange, a group mortgage reinsurance facility involving unaffiliated lenders. These determinations had not been overturned by any court as of January 1, 1999, (nor have they been overturned subsequent to that date). Accordingly, mortgage reinsurance, including such reinsurance offered through a group facility involving unaffiliated lenders, satisfies the "authorized product" exception in Section 302 of the GLBA.[9]

III. Conclusion

Accordingly, the activities of the reinsurer are substantively the same as those of a group mortgage reinsurance facility previously authorized by the OCC, and thus, a national bank seeking to make a non-controlling investment, directly or indirectly through an operating subsidiary, in the Reinsurer, may use the notice procedure available under 12 CFR 5.36(e),[10] if the bank otherwise qualifies under the criteria of that section.

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[8] *See, e.g.,* Corporate Decisions No. 97–97 (November 10, 1997) (First Tennessee); No. 97–93 (October 20, 1997) (SunTrust); No. 97–89 (September 26, 1997) (Norwest); No. 97–27 (May 2, 1997) (Bank One); No. 97–15 (March 17, 1997) (PNC); and No. 97–06 (January 22, 1997) (Chase); and Interpretive Letter No. 743, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶81-108 (October 17, 1996).

[9] *See also,* Corporate Decision 2001–10 (April 23, 2001) (OCC approved, after January 1, 1999, credit-related reinsurance activities in connection with loans of both affiliated and unaffiliated lenders, because the OCC had established the authority of national banks and their subsidiaries to reinsure credit-related products in connection with the bank's and other lenders' loans, prior to January 1, 1999).

[10] If a national bank seeks to make a noncontrolling investment in the Reinsurer through an operating subsidiary, the bank must ensure that it complies with the applicable requirements of 12 CFR 5.34.