

INTERPRETATIONS— OCTOBER 1 TO DECEMBER 31, 2002

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Interpretive Letters

945—June 30, 2000

12 CFR 3

Dear []:

This is in response to your presentation of June 6, 2000, requesting an opinion on the risk-based capital treatment for a proposed portfolio credit default swap transaction. In your presentation, you request approval to substitute a 20 percent risk weight for a 100 percent risk weight on a portfolio of reference assets because of the credit protection purchased from [state trust company] ([] or counterparty). Subject to the conditions described in this letter, the Office of the Comptroller of the Currency (OCC) approves this capital treatment for the first two and a half years of the proposed transaction. During the year preceding the repricing of the transaction, additional capital will be required as described below.

Background

In the proposed transaction, [NB1] and [NB2] (together, [NB1] or the bank) would purchase default protection via a credit default swap referencing a portfolio of the bank's ABS/MBS securities. The portfolio consists of approximately 107 reference assets with a minimum rating of Aaa by Moody's or AAA by S&P [Standard & Poor's]. The weighted average credit quality of the reference securities is AAA/Aaa and the expected weighted average maturity is 3.7 years. The maximum final maturity of the portfolio is 35 years. Over the term of the transaction the bank will have the ability to replace securities that have amortized or matured. The bank may, at its option, substitute or replace reference assets according to certain eligibility criteria and guidelines agreed to by the bank and its counterparty.

The credit default swap purchased by the bank would have a final maturity of 35 years. However, the bank has the right to terminate the transaction in one year and every six months from that date in the event of a regulatory capital change that would permit the bank to assign a risk weight of less than 100 percent to the underlying portfolio or a risk weight greater than 20 percent to the counterparty in the transaction. The bank may call the transaction for any reason after 18 months and every six months thereafter. If in three and a half years the bank has not exercised these options, the premium paid by the bank to its counterparty will be refixed based on then-prevailing market prices and the outstanding portfolio amount. If the bank experiences a credit loss on any of the reference assets, the counterparty will pay the bank an amount equal to the loss on the security at maturity or at the call date if the transaction is called by the bank.

Risks to the Bank

The transaction described above poses risks to the bank for which the OCC requires adequate risk-based capital. The reference assets for which the bank has purchased credit protection have various final maturities, the longest of which is 35 years. However, the bank has obtained protection against credit losses on the reference securities for effectively three and a half years. The refixing of the premium on the credit default swap in three and a half years is equivalent to entering into a new credit protection arrangement since the refixed premium will be based on then-prevailing market prices and condition of the underlying portfolio. Although the proposed transaction protects the bank from default events of any of the reference assets, it does not protect the bank from changes in value of the reference assets due to deteriorating credit quality of the issuers or changes in market conditions. The bank has purchased protection only on credit losses, i.e., a reduction in the principal of a reference asset or a failure to pay by the issuer. Although the counterparty has committed to continue to provide credit protection after three and a half years, the repricing feature leaves the bank exposed to the risk of credit deterioration in the reference assets.

Risk-Based Capital Treatment

The credit default swap enables the bank to transfer the credit risk of the portfolio of reference assets to the counterparty. Since the counterparty is obligated to reimburse the bank for any credit losses in the reference assets, the proposed credit derivative transaction is functionally equivalent to a standby letter of credit issued by the counterparty. During the period of effective credit protection, the bank's credit risk exposure under the proposed transaction is to the counterparty. Therefore, under 12 CFR Part 3 appendix A, the bank may substitute the risk weight of the counterparty, an OECD [Organization for Economic Cooperation and Development] bank (20 percent), for that of the reference assets. However, because the maturity of the proposed credit protection is effectively three and a half years (significantly shorter than the final maturity of some of the reference assets), the bank will be exposed to the credit risk of the reference assets in three and a half years. The OCC believes it is appropriate that the bank increase the regulatory capital held for the risks of the reference assets during the year prior to the effective maturity date of the transaction.

Starting with the end of the fourth quarter prior to the effective maturity date of the transaction (i.e., the repricing date), the bank should recognize only a portion of the credit protection provided by the counterparty. The portion of credit protection recognized would decrease over the last year, effectively increasing regulatory capital, so that at the end of the last quarter prior to the effective maturity date the full amount of regulatory capital for the unprotected reference assets is allocated for the portfolio. Specifically, when calculating risk weighted assets at the end of the fourth quarter prior to the effective maturity date, the bank would recognize the credit protection provided by the counterparty for only 75 percent of the underlying portfolio, i.e., 75 percent of the underlying portfolio would receive the risk weight of the counterparty and 25 percent would

receive the risk weight appropriate for the reference assets. At the end of the third quarter prior to the effective maturity date, 50 percent of the reference assets would receive the risk weight of the counterparty and 50 percent would receive the risk weight of the reference assets. At the end of the second quarter prior to the effective maturity date, only 25 percent of the reference assets would receive the risk weight of the counterparty. At the end of the last quarter prior to the effective maturity date, 100 percent of the reference assets would be considered unprotected. Assuming the reference assets are otherwise subject to a 100 percent risk weight, the effective risk weight on the portfolio would be 40 percent at the end of the fourth quarter, 60 percent at the end of the next quarter, 80 percent at the end of the second to last quarter, and 100 percent at the end of the last quarter.

As part of this risk-based capital interpretation, the OCC carefully considered the high credit quality of both the reference assets and the counterparty. The OCC also considered the bank's ability to adequately manage and monitor the risks of the transaction. The bank must continue to manage and maintain adequate regulatory capital for the credit risk of its assets that has not been transferred as a result of this transaction. The proposed transaction does not confer any benefits to the bank for purposes of calculating its Tier 1 leverage ratio because the reference assets remain on the bank's balance sheet.

Additionally, under the substitution agreement between the bank and the counterparty the bank may substitute an asset with a higher rating than that of the asset it is replacing. However, such a substitution might raise questions concerning the actual transference of credit risk of the reference assets to the counterparty and could result in the OCC reconsidering the capital treatment outlined in this letter.

This risk-based capital treatment applies only to transactions that meet the description and satisfy the conditions outlined in this letter. If you have further questions, please do not hesitate to contact the resident OCC examiners, the Capital Policy Division on (202) 874-5070, or the Treasury and Market Risk Division on 202-874-5670.

Tommy Snow
Director, Capital Policy

946—September 27, 2001**12 CFR 3**

Dear []:

This letter is in response to your April 30, 2001, letter to Jennifer Burns and Morris Morgan requesting a risk-based capital interpretation for a series of credit derivative structures. In addition, your letter poses a number of questions concerning the application of 12 CFR 3, appendix B; 12 CFR 208, appendix E; and 12 CFR 225, appendix E (“market risk rules”) and the proposal “Risk Based Capital Standards; Recourse and Direct Credit Substitutes”¹ (“proposed rules”) to credit derivatives. This letter provides views as to the appropriate risk-based capital treatment for all but one of the structures described. On the fifth structure, the variable funding credit-linked note, we are unable to provide a risk-based capital interpretation until more details are provided concerning the structure. The capital treatment set forth below for individual scenarios may not apply when the individual elements are combined together in one transaction. As a result, both the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System (FRB) will continue to follow a case-by-case approach to risk-based capital interpretations for synthetic securitizations and credit derivatives transactions.

Background

[] (the “bank”) is considering providing second loss protection to a foreign OECD [Organization for Economic Cooperation and Development] bank (“the counterparty”) on a portfolio of margin loans (“reference portfolio”) originated in individual brokerage accounts in the U.S. The size of the pool will vary over time and is expected to be very diverse (over 1,000 borrowers). For illustrative purposes you have assumed a notional amount for the portfolio of \$5 billion. The counterparty will retain a first loss position of 2 percent per year and the third loss position. The bank will assume the second loss position, not to exceed 10 percent of the portfolio over the life of the transaction. The second loss position is expected to be rated BBB. The maturity of the loans in the portfolio is not well defined, but the credit protection provided by the bank will have a final maturity of 3 years and a call option exercisable by the counterparty after 2.5 years.

In your letter, you describe five possible transaction structures by which the bank could assume the second loss position on the reference portfolio: (1) cash securitization, (2) credit linked note (CLN), (3) credit default swap (CDS) referencing a CLN held by the counterparty, (4) CDS directly on the reference portfolio, and (5) variable funding credit linked note (VFCLN).

¹ 65 *Fed. Reg.* 12320 (March 8, 2000)

Bank's Questions

Structure 1: Cash Securitization

In your letter you describe the banking book and trading book risk-based capital calculation for a cash securitization. As part of your description of the trading book calculation, you indicate that “there would also be the applicable Counterparty Risk charge.” Please note that a counterparty credit risk charge is not required for a cash security held by the bank in its trading book because under the market risk rules, such a charge applies only to over-the-counter derivatives and foreign exchange contracts.

Question 1: Were the Proposed Rules intended to apply only to banking book treatment, or would they affect the trading book treatment as well?

For banking organizations that do not apply the market risk rules, the proposed rules are intended to apply to positions in both the banking book and trading book. For banking organizations that comply with the market risk rules, the proposed rules, if adopted, would apply only to positions in the banking book and the market risk rules would apply to positions in the trading book (including those arising out of securitizations).

Structure 2: Credit Linked Note

Question 2: We are under the impression that OCC 99–43, FRB SR 99–32 was intended to apply only to the banking book. This is based primarily on the reliance on risk-weights when determining the capital charge for a bank investing in the notes of the synthetic CLO and the fact that no specific mention was made of the trading book. Are we correct in this assumption? If so, would the trading book treatment be identical to that described in Structure 1: Cash Securitization?

The capital treatment articulated in OCC 99–43 and FRB SR99–32 applies to the agencies’ current leverage and risk-based capital guidelines. Although not explicitly stated, the OCC and FRB intended the capital treatment articulated in OCC 99–43 and FRB SR 99–32 to apply to CLNs held in the banking book. Banks investing in CLNs are required to use the higher of the risk weight applicable for the underlying reference asset or the issuer of the CLNs. If the bank holds a CLN in its trading book and it complies with the market risk rules, it must calculate the general market risk and specific risk capital charges for its investment in the CLN. The bank should use its own internal value-at-risk (VAR) model to calculate the capital charge for general market risk. A bank may use its VAR model to calculate its specific risk charge, if accepted by its supervisor, or the standard approach described in the market risk rules. If a bank uses the standard approach for specific risk, it may use the rating on the CLNs to determine the appropriate charge.

Question 3: Generally, what would be the appropriate notional amount to which the risk-weight should be applied under OCC 99-43, FRB SR 99-32—the notional amount of the note purchased or the notional amount of the underlying portfolio? For example, if a synthetic CLO had a \$100 million BBB tranche referencing a \$10 billion portfolio and SCP (“Structured Credit Products Group”) purchased \$20 million of that tranche, to what notional should the risk-weight be applied to calculate the capital charge against the \$20 million position?

The risk weight should be applied to the maximum amount the bank could lose from its investment. For example, if a bank purchased rated CLNs with a face amount of \$20 MM and the maximum amount the bank could lose is \$20 MM, the appropriate risk weight would be applied to \$20 MM.

Question 4: Was it the intention of the Proposed Rules to give synthetic securitizations and cash securitizations the same capital treatment?

The proposed rules generally are intended to treat recourse obligations and direct credit substitutes more consistently than under the current risk-based capital standards, as well as to better match capital requirements to credit risk exposure. To the extent that synthetic securitizations and cash securitizations pose the same economic risk to a bank, the proposed rules, if adopted, should result in similar risk-based capital requirements.

Structure 3: Credit Default Swap Referencing a CLN Held by the Counterparty

Question 5: Would the notional amount of the CLN on which the default protection is written be the correct notional to use in the calculation of the Specific Risk capital charge and the Counterparty Risk capital charge?

In this structure, the bank has entered into a derivative contract with its counterparty. The market risk rules require that in determining the standard specific risk charge “for debt positions that are derivatives, a bank must risk weight . . . the market value of the effective notional amount of the underlying debt instrument.” (Section 5(c)(1)(i)(A) of 12 CFR 3, appendix B, and 12 CFR 225, appendix E). The CLN is the debt instrument underlying the CDS. The standard specific risk charge for the bank should be calculated based on the market value of the underlying CLN and the rating of the CLN.

In the described transaction the bank has sold credit protection to the counterparty in return for a premium. The bank’s only credit exposure to the counterparty is future premiums, which, if discontinued, eliminate the bank’s obligation to provide protection. Therefore, a counterparty risk capital charge is not necessary.

Question 6: Is a literal reading of FRB SR 97–18 appropriate for the calculation of capital in this case?

We assume that you are referring to the treatment for specific risk of credit derivatives described in FRB SR 97–18, “Application of Market Risk Capital Requirements to Credit Derivatives.” The SR letter states that “standard specific risk charges for credit derivatives may be calculated using the specific risk weighting factors that apply to the referenced asset.” In the case of a CDS referencing a rated CLN, the referenced asset is a rated CLN. For the transaction described, the bank should calculate the standard specific risk charge by applying the risk weight appropriate for a debt instrument with the same rating and maturity as the CLN to the market value of the CLN.

Structure 4: Credit Default Swap

Question 7: Would the CDS notional be the correct notional against which to apply the risk-weight in this scenario? [Banking book treatment]

Under the current banking book rules, the CDS would be treated as a direct credit substitute. The CDS is equivalent to a guarantee type standby letter of credit on third-party assets. To calculate the risk-based capital requirement for a standby letter of credit, the bank would apply the appropriate risk weight to the face amount of the letter of credit. In the transaction described in your letter, the bank would apply a 100 percent risk weight to the size of its second loss position, which is 10 percent of the underlying reference portfolio. If the CDS is structured in such a way that the bank could lose more than the notional amount of the CDS, that larger amount should be risk weighted.

However, if the proposed rules are adopted, the risk-based capital requirement could be significantly different. The bank’s position would be treated as a non-traded and unrated position. The bank’s risk-based capital charge would be the appropriate risk weight, 100 percent, applied to its second loss position plus the senior risk positions that it supports, subject to low-level recourse rules.

Question 8: What would be the appropriate notional on which the capital charge should be calculated for the Specific Risk charge and the Counterparty Risk charge? [Trading book treatment]

The market risk rules require a bank to apply the specific risk weight factor to the “effective notional amount” of the underlying reference asset. However, the rules do not explicitly define “effective notional amount.” In the transaction described, the bank is providing second loss credit protection on the reference portfolio. The bank’s potential credit losses are limited to 10 percent of the reference portfolio. Based on the specific facts of the transaction described in your letter, we believe the term “effective notional amount” should be interpreted to mean the bank’s loss exposure under the CDS. The bank may apply the specific risk weight factor to the maximum amount the bank could lose on the CDS.

In the described transaction the bank has sold credit protection to the counterparty in return for a premium. The bank's only credit exposure to the counterparty is future premiums. Therefore, a counterparty risk capital charge is not necessary.

Question 9: If the swap itself were rated investment grade, could the Specific Risk charge be calculated as $1.6\% \times \$500 \text{ million} = \8 million rather than \$40 million? In other words, although this does not follow from a literal reading of FRB SR 97-18, given that this structure is economically identical to Structure 3 above,² should it be treated differently under the capital rules?

FRB SR 97-18, which addresses trading book capital requirements, was issued four years ago when credit derivatives were relatively new instruments and CDS's were not rated. Since then, the market for credit derivatives has evolved and rated CDS's are increasingly common. We believe that an investment grade rating on a CDS provides information on the credit quality of both the underlying reference portfolio and the level of prior enhancement. A case can be made that the rating of a CDS should be used to determine the specific risk weighting factor in the calculation of the standard specific risk capital charge. The specific risk capital charge would be \$8 MM.

Question 10: Was it the intention of the Proposed Rules that a rated CDS such as the one described would be treated the same as a cash and/or synthetic securitization?

The proposed rules are intended to treat recourse obligations and direct credit substitutes more consistently than under the current risk-based capital standards and better match capital requirements to credit risk exposure. The proposed definition of direct credit substitute includes credit derivative contracts under which a bank assumes more than its *pro rata* share of credit risk on a third-party asset. To the extent that a rated CDS poses the same risks to the bank as cash securitizations, the proposed rules, if adopted, should result in similar risk-based capital requirements.

Structure 5: Variable Funding Credit Linked Note

Question 11: Would the capital treatment of the VFCLN be any different from the standard CLN or the cash securitization discussed above?

As described in your letter, the VFCLN appears similar to a CDS. As in a CDS, the bank has a cash outflow only when a loss on the reference portfolio occurs, and is unlikely to recover that cash payment from recoveries on the underlying reference portfolio. With CLNs or cash

² The two would be economically identical provided that the terms of the CDS in Structure 4 and the CDS and CLN in Structure 3 were specified appropriately. All cashflows would be identical both in timing and amount.

securitization, the credit protection seller “purchases” the instrument via a cash outflow and receives a return of that investment less any losses. Since the VFCLN structure is new, we are hesitant to opine on a risk-based capital treatment until we review the specific terms of the note.

Conclusion

This letter outlines our views on a variety of credit derivative structures. The risk-based capital treatments outlined in this letter apply only to transactions described in your letter. The treatment of other transactions will depend on the structure and terms of those transactions. The OCC and FRB continue to review and issue risk-based capital interpretations on credit derivative transactions on a case-by-case basis. If you have further questions, please do not hesitate to contact the resident OCC examiners, Margot Schwadron in the Capital Policy Division on (202) 874–6022, or Kurt Wilhelm in the Treasury and Market Risk Division on (202) 874–4479, or Tom Boemio in the Supervisory and Risk Policy Division of the FRB at (202) 452–2982.

Tommy Snow
Director, Capital Policy
Office of the Comptroller of the Currency

Barbara Bouchard
Assistant Director
Board of Governors of the Federal Reserve System

947—May 28, 2002

12 CFR 3

Subject: Risk-Based Capital Treatment for Purchase of Interests in Master Trust

Dear []:

This letter is in response to a request regarding the appropriate risk-based capital treatment stemming from the February 5, 2002, purchase by [] (“the bank”) of a portfolio of credit card accounts and receivables from [bank 2]. Outstanding receivables, securitized in the [bank 2] master trust, were approximately \$7.6 billion. The purchase included approximately \$1.3 billion of seller’s interest; approximately \$6.3 billion of investor interests are outstanding. The purchase also included a combination of subordinated interests, cash collateral, and other residual interests valued at approximately \$600 million.¹ Under generally accepted accounting principles, the bank cannot initially avail itself of the nonconsolidation guidance of Statement of Financial Accounting Standards No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,” because the bank was not the original transferor of the assets held in the master trust. Consequently, the bank must initially consolidate the master trust and account for the previously sold receivables as a financing.

Sales treatment will apply to new receivable balances transferred into the trust to replenish those that are paid down. It will take an estimated 14 months for substantially all the receivables existing at the acquisition date to completely turn over, resulting in full sales treatment.

Issues

Under the recently published final rule, “Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations,”² unrated residual interests in securitized assets attract a dollar-for-dollar capital charge. Sellers’ interests (i.e., pro rata claims) are generally risk weighted in accordance with the underlying receivables. Therefore, if the bank received sales treatment on the above transaction, it would hold a minimum of \$704 million risk-based capital, as calculated below:

Residual interests (dollar-for-dollar)	\$600
Seller’s interest (\$1.3 billion X 100 percent risk weight x 8 percent) (not certificated; unrated; shares losses pro rata with investors’ interests)	<u>104</u>
	<u>\$704</u>

¹ This is a simplified summary of our understanding of the transaction, based on our discussions with bank staff. Additional assets and reserves included in the purchase are ignored for simplicity in this discussion.

² See 66 Fed. Reg. 59614 (November 29, 2001).

The bank has expressed concern that, under the new residual interest rule, as soon as the transaction qualifies for partial sales treatment, the entire residual interest will be subject to a dollar-for-dollar capital charge, and the remaining on-balance receivables backing the investor interests will be risk weighted at 100 percent. This would result in a capital charge of as much as \$1.2 billion (dollar-for-dollar on \$600 million in residual interests, plus 8 percent of the \$7.6 billion on-balance-sheet receivables). Because the dollar-for-dollar capital charge on the residual interests captures credit-enhancement on the “sold” receivables that continue to be accounted for as a financing, you believe this would result in capital being double-charged for the same credit risk. The Office of the Comptroller of the Currency (OCC) agrees that this potential double-charging was not intended under the new rule.

Regulatory Provisions

The new recourse/residual interest rule contemplated the potential for double-charging when a residual interest supports transferred assets that are subject to other contractual recourse provisions as well. *See* 12 CFR Part 3, appendix A, section 4(f)(4).³ However, it does not appear that the unique accounting provisions encountered in this acquisition were contemplated in the new regulation; there are no similar provisions to directly address potential double-charging when a residual interest supports *on*-balance-sheet receivables.⁴

The rule also expanded the OCC’s reservation of authority provisions found at 12 CFR 3.4(b). These provisions permit the OCC to determine a different risk weight than otherwise required by the risk-based capital regulations.

OCC Determination

We have determined that the bank’s minimum risk-based capital requirement should be based on the higher of (1) the booked residual interest (i.e., up to \$600 million—dollar-for-dollar) *plus* 8 percent of the risk-weighted seller’s interest; or (2) 8 percent of on-balance-sheet risk-weighted assets (as well as any off-balance-sheet receivables sold subject to recourse other than the residual), but not both. Thus, the initial charge would be \$704 million, which represents the dollar-for-dollar charge on the \$600 million residual, plus 8 percent of the \$1.3 billion seller’s

³ Section 4(f)(4) provides: “*Residual interests and other recourse obligations.* Where the aggregate capital requirements for residual interests (including credit-enhancing interest-only strips) and recourse obligations arising from the same transfer of assets exceed the full risk-based capital requirements for those assets, a bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under sections 4(f)(1) through (3) of this appendix A or the full risk-based capital requirement for the assets transferred.”

⁴ Twelve CFR Part 3, appendix A, section 4(h)(2) provides that if an asset is included in the calculation of the risk-based capital requirement under the recourse/residual interest provisions (section 4) and also appears as an asset on a bank’s balance sheet, the asset is generally risk-weighted only under section 4. This ensures that on-balance-sheet residual interests that are subject to a dollar-for-dollar capital requirement are not also risk weighted. It does not appear to address the situation where the underlying loans supported by the residual interest are also on-balance-sheet.

interest (\$104 million). This amount must be compared to the \$656 million risk-based capital charge on the on-balance-sheet assets (8 percent of \$7.6 billion on-balance-sheet receivables plus \$600 million residual interest, all assumed to be risk weighted at 100 percent), and the higher of the two applies. The result will be a risk-based capital charge that is consistent with either full sales treatment or full financing treatment, but that avoids double-charging for the blended accounting treatment applicable to this transaction. We believe this approach to be generally consistent with the methodology used in 12 CFR Part 3, appendix A, section 4(f)(4), as well as the underlying purpose of that regulatory provision—preventing the double-counting of both recourse obligations and residual interests. However, because the current capital regulations do not explicitly provide an exception to risk-weighting the entire on-balance-sheet receivables, in addition to the charge on the residual interests, we rely on our reservation of authority pursuant to 12 CFR 3.4(b) to determine the appropriate risk weight in light of the specific features of the transaction you have described.

This determination is made specifically under the facts presented in this particular transaction, and may not be relied on for determining the risk-based capital treatment of any other transaction, or for determining the risk-based capital treatment of any components of this transaction other than the residual interests, the seller's interest, and the related on-balance-sheet receivables. This determination does not affect the bank's calculation of its leverage ratio, which will continue to be based on adjusted total assets as defined in 12 CFR 3.2(a).

If you have questions or need additional information, please contact me or Amrit Sekhon at (202) 874-5070.

Tommy Snow
Director, Capital Policy

948—October 23, 2002

12 USC 24(7)

Ann Johnson
Counsel
Federal Deposit Insurance Corporation
550 17th Street, N.W., 3rd Floor
Washington, DC 20429

Dear Ms. Johnson:

This is in response to your query whether a national bank, pursuant to 12 USC 24(Seventh), may purchase and sell transferable state tax credits. For the reasons discussed below, we conclude that a national bank may engage in such activity.

Background

In several telephone conversations with Office of the Comptroller of the Currency (OCC) staff, you asked whether a national bank (“bank”) may purchase and sell transferable Missouri state tax credits.¹ The bank would purchase the tax credits and then would either use the tax credits to reduce its own tax liability or sell the tax credits to individuals and businesses able to use the credits to reduce their tax liabilities. In most cases where the bank purchases tax credits for resale, the bank would do so with written purchase commitments in place from potential buyers. Moreover, you indicated that demand for these tax credits typically exceeds their supply during tax season and that, in the event that a purchaser fails to honor his commitment to purchase or the bank purchases tax credits without having identified a buyer, bank management believes the bank would have no difficulty in finding a third party to complete a sale.

You further indicated that the purchase and transfer of Missouri state tax credits is a noncomplex and fairly rapid process. After the bank and a third party execute a tax credit transfer agreement, the parties complete and execute the Missouri transfer request application and file the application, a copy of the purchase agreement, and the existing tax credit certificate with the State of Missouri. Once the transfer is approved, the State of Missouri issues a certificate to the new owner evidencing the purchaser’s right to claim the tax credits.

¹ Some state tax credits can be transferred from one taxpayer to another once they have been awarded (“transferable” credits), while others can only be used by a taxpayer who retains an equity or ownership interest in the qualified project. The bank proposes to purchase and re-sell only transferable credits.

Discussion

The courts and the OCC have recognized that, when reduced to their essence, national banks serve as financial intermediaries for the public. In other words, the public looks to national banks to facilitate the flow of money and credit among different parts of the economy. *Auten v. U.S. Nat'l Bank of New York*, 174 U.S. 125 (1899); Interpretive Letter No. 929, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,454 (February 11, 2002); Interpretive Letter No. 494, *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083 (December 20, 1989). Indeed, it has been long recognized that “[t]he very object of banking is to aid the operation of the laws of commerce by serving as a channel for carrying money from place to place, as the rise and fall of supply and demand require.” *Auten*, 174 U.S. at 143.²

Moreover, the evolutionary nature of the business of banking and the necessity of national banks’ developing new products and services to keep up with the changing financial needs of the economy are now well established in case law. *See, e.g., M & M Leasing Corp. v. Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977) (confirming the authority of national banks to lease motor vehicles stating: “we believe the powers of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking”) *cert. denied*, 436 U.S. 956 (1978); *American Insurance Association v. Clarke*, 865 F.2d 278, 281 (rejecting “a narrow and artificially rigid view of both the business of banking and the [National Bank Act]” which would have prevented national banks from providing municipal bond insurance as a new form of a traditional banking product). The purchase and sale of transferable state tax credits fits within the powers of national banks because it is simply a new way of tailoring traditional financial intermediation services to meet the needs of bank customers.

The role of a bank intermediary takes many forms: borrowing from savers and lending to users, 12 USC 24(Seventh); buying and selling tax lien certificates, Interpretive Letter No. 725, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–040 (May 10, 1996); and brokering financial instruments, Interpretive Letter No. 717, *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–032 (March 26, 1996). As the recognized intermediaries between other, non-bank participants in the financial markets, banks possess the expertise to effect transactions between parties and to manage their own intermediation position. Interpretive Letter No. 929, *supra*.

The traditional manner for national banks to carry out the function of channeling available funds from points of surplus to points of demand is to receive funds from one source and make them available to another source—as is the case when deposits are received and loans originated. The

² *Accord* No-Objection Letter No. 90–1, *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095 (February 16, 1990); Interpretive Letter No. 387, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,602 (March 24, 1987).

purchase and sale of transferable state tax credits moves funds from sources of supply to sources of demand. Tax credits offset a tax liability, dollar-for-dollar, and therefore are the functional equivalent of money. By purchasing and selling tax credits, a national bank is engaging in both a permissible role—that of financial intermediary—and a permissible activity—facilitating the flow of money. Therefore, purchasing, holding, and subsequently reselling transferable state tax credits is a permissible activity for national banks under Section 24(Seventh).

Conclusion

For the reasons stated above we conclude that, pursuant to 12 USC 24(Seventh), a national bank would have the legal authority to purchase and sell transferable state tax credits. If you have any questions, please contact Senior Attorney Steven Key at (202) 874-5300.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel