



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 4, 2006

The Honorable Barney Frank
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Frank:

I am writing in response to your letter dated March 29, 2006, which raised concerns with three interpretive letters recently issued by the OCC: two dealing with the authority of national banks to own different types of bank premises (the "Bank Premises Letters"),¹ and one dealing with an energy project financing transaction (the "Project Financing Letter").²

You express concerns that these letters reflect a significant departure from statutory requirements and previous OCC interpretations and that they may permit a backdoor to mix banking and commerce. To clarify these issues, you have asked several specific questions.

Before addressing your specific questions, I would like to assure you that the letters to which you refer do not enable national banks to get into the real estate investment or development business (nor do they have anything to do with real estate brokerage); they do not undermine the fundamental separation of banking and commerce that distinguishes our nation's banking system; and they do not endanger the deposit insurance funds.

The statutory authority of national banks to invest in real estate, both before and since the Gramm-Leach-Bliley Act was enacted, has been and continues to be subject to very substantial limitations and constraints. This limited authority, however, does enable national banks to take direct and indirect interests in real estate in connection with conducting their own banking business. Over the past century, the courts and the OCC have interpreted this limited authority to permit – or to prohibit – particular types of activities, based on particular facts.

The Bank Premises Letters that prompted your inquiry deal only with limited situations where holding an interest in real estate is permissible for national banks. They are based upon decades-old judicial precedent and OCC interpretations that expressly recognize that a national bank may

¹ Interpretive Letters No. 1044 and 1045 (Dec. 5, 2005).

² Interpretive Letter No. 1048 (Dec. 21, 2005).

hold and develop property used for its own operations and lease or sell the portion of the premises that the bank does not use. This authority, however, is subject to substantial limitations, including the requirement that the development must not be speculative or motivated by realizing a gain on appreciation of the real estate property value. In each letter, we concluded that the bank demonstrated that the proposed bank premises development was justified by a legitimate and good faith business need for accommodation of the bank's business activities. Thus, the Bank Premises Letters do not lay a foundation for national banks' engaging in the real estate development (or brokerage) business.

The Project Financing Letter is based on precedents recognizing that, in limited circumstances, a bank may hold a limited interest in a borrowing entity or its assets as an integral component of a financing arrangement. The restrictions and limitations in this letter make clear that our approval is premised on the bank's interest being structured so as to preserve its economic substance as a loan, rather than an equity investment. In particular, unlike a traditional controlling equity investment, the bank (1) may not participate in the operation of the business receiving the bank's financing; (2) may not realize any gain on the appreciation of the value of its interests in the business or assets held by the business; and (3) must provide in the project agreement many of the same terms, conditions, and covenants typically found in lending and lease financing transactions to protect its interests.

Let me also make clear that the reason the OCC permitted this financing transaction to be structured as an equity investment was to allow the bank to capture tax benefits that were enacted to promote the flow of capital to alternative sources of energy. For similar reasons – that is, to capture tax benefits that Congress has authorized to promote certain types of projects – the OCC has long permitted national banks to provide financing that takes the form of equity, e.g., to finance low-income housing, the renovation of historic buildings, and other types of community development projects. These transactions, discussed further in response to your questions below, have proven to be low risk, and like the alternative energy financing here, provide an important source of capital to projects that Congress, by providing tax credits in connection with such investments, affirmatively has sought to promote.

In all three of these letters, the OCC supervisors of the banks involved concluded that the activities proposed were consistent with the safe and sound operations of the banks. Going forward, the OCC will continue to monitor these activities to ensure that they are conducted in a safe and sound manner.

I next will address your specific questions.

(1) Please explain why "owning" a hotel (as opposed to simply leasing space to a third-party owned hotel company) is "necessary for [a national bank's] accommodation in the transaction of its business."

Section 29 provides that national banks may purchase, hold, and convey real estate "such as shall be necessary for its accommodation in the transaction of its business." 12 U.S.C. § 29. (The real estate at issue here is a building, which the bank would still own, even if it leased all the space to a third party hotel company.) The courts, in the context of section 29 and in the context of

section 24(Seventh), where the term also appears, do not construe the term "necessary" to mean "indispensable" or "absolutely required."³ Thus, long-standing OCC precedent has permitted bank premises to take different forms, such as office buildings, parking lots, storage facilities, and lodging, and has not required a showing that the facility was a necessity or that a bank's business would be harmed, without the particular facilities as proposed. Rather, judicial and OCC precedent require that the facilities must be acquired (or constructed) in good faith and demonstrably in furtherance of a bank's banking operations.

This principle applies to lodging space,⁴ as well as to office space, parking lots, and storage facilities. National banks may develop and own an office building, for use by bank employees, and lease excess office space to third-parties; may own real estate used as a parking lot for bank employees, with excess parking space available to the public; and also may develop and own a storage facility, for use by the bank, and lease excess storage space to third-parties.

This authority is very limited, however, and is available only on a case-by-case basis where a proposed facility clearly furthers the banking business of the bank, and is not being undertaken for speculative purposes or to undertake an otherwise impermissible activity. In the case of office, parking, storage, or lodging space, the relative percentage of use by the bank, compared to third parties, is an important indicator of the bank's good faith use of the property in furtherance of its banking operations. This is the analysis we applied in the Bank Premises Letters to determine that the proposals in question were consistent with precedent and permissible.

Moreover, the authority pertains to the ownership of real estate, here, two buildings, in the limited circumstances allowed. It is not an authorization for, and the letters did not permit, the banks in question to operate the hotel business that would occupy the buildings. Indeed, the letters were very specific that these non-banking businesses would be operated by independent third-party companies. The letters do not serve as precedent for allowing national banks to engage generally in the hotel business, such as owning a chain of hotels.

³ See *Wells Fargo Bank, N.A. v. Boutris*, 419 F.3d 949 (9th Cir. 2005); *Security Industry Ass'n v. Clarke*, 885 F.2d 1034 (2nd Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990); *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978); *Arnold Tours, Inc. v. Camp*, 472 F.2d 427 (1st Cir. 1972); *Morris v. Third Nat'l Bank*, 142 F. 25 (8th Cir. 1905), *cert. denied*, 201 U.S. 649 (1906); *Exchange Bank of Commerce v. Meadors*, 184 P.2d 458 (Okla. 1947); *Trustees of First Presbyterian Church v. National State Bank*, 29 A. 320 (N.J. 1894).

⁴ Interpretive Letter No. 1043 (July 8, 1993) (national bank may lease condominium, used for out-of-area bank visitors, to third-parties when not in use by bank visitors); Interpretive Letter No. 1042 (Jan. 21, 1993) (national bank may hold condominium for use of out-of-area visitors); Interpretive Letter (Sept. 13, 1993) (available in Lexis-Nexis) (bank, if it were national bank, could retain ownership of residences used by executives of bank's foreign parent on long-term rotations); Interpretive Letter No. 2 (Dec. 13, 1977) (national bank may own apartment in Los Angeles for use by its CEO who maintains his primary residence elsewhere).

(2) *Would this same argument to allow the ownership of a hotel not also permit the national bank to own restaurants in the building (e.g., the bankers' and their visitors will need to eat), and a car rental company (e.g., they will also need transportation)?*

Please see the immediately preceding response. The theory and criteria that we used in the Bank Premises Letters involved the appropriate use of *real estate* owned by the bank, here, hotel real estate. But owning the hotel real estate, which was permitted based on specific limitations and representations made by the banks involved, is different from owning the business that operates the hotel, which was not permitted. The operation of the hotel business was to be conducted by an independent, third-party hotel management company, and that limitation was key to our interpretation.

Thus, the Bank Premises Letters would not be precedent that would allow a bank to own a car rental business, which primarily involves the use of personal property (cars), not real estate. The Letters have no application to personal property leasing, such as car rentals. In addition, national banks are not authorized to engage in the car rental business.

With respect to restaurants, our precedent does permit a bank to own real estate – a building – that houses a commercial restaurant that serves bank staff and visitors, as well as the general public. But the authority to own a *building* in which a restaurant business is conducted – the real estate – does not authorize a bank to own or operate a commercial restaurant business. Nor are banks authorized to engage generally in the restaurant business, such as by owning a chain of restaurants.

(3) *Are there not greater risks to the bank (and the deposit insurance funds), if the bank actually owns the hotel rather than leasing the space to a hotel company?*

Hotel construction and development, related financing arrangements, and leasing and operating arrangements can take a variety of forms presenting different levels and types of risk. As noted above in response to question # (1), the real estate at issue here is a building, which the bank would own, whether it contracted with a third party hotel company to operate a hotel business on the property or leased space in the building to a third party hotel company to operate the hotel business. Even with respect to leases, there are a range of potential lease structures that present different ranges of risk and cost exposures. Thus, it is impossible to generalize whether lease arrangements are more or less risky than other arrangements that achieve the same permissible result – providing convenient accommodations for bank employees, officials, customers, and third party vendors when visiting the bank.

Even if relative risks could be precisely determined, we do not, as a matter of bank supervision, require that banks structure any particular type of transaction in the least risky form possible. For example, there are structures that involve increased risk, but also substantially reduce costs and are wholly permissible. We require that the structure be legal, and safe and sound, and as a part of the latter, we expect a bank to have proper systems and controls in place to monitor, manage, and control its risks.

It is also important to note that existing Federal law already imposes checks on the extent to which national banks can have exposures in connection with bank premises. Under 12 U.S.C. § 371d, a national bank's investment in bank premises (and investments in or loans to corporations holding bank premises) may not in an aggregate amount exceed the bank's capital stock, unless the bank first submits an application to the OCC and obtains approval for such investment or loan. 12 U.S.C. § 371d(1) and (2). For a well-capitalized national bank with a CAMELS composite rating⁵ of 1 or 2, the bank may invest in bank premises (and make investments in or loans to corporations holding bank premises) in an aggregate amount up to 150 percent of the bank's capital and surplus provided that the bank provides the OCC with notification of such investment or loan. 12 C.F.R. § 371d(3). These limitations and the requirements of the application and notice are implemented by OCC regulation. See 12 C.F.R. § 5.37.

The proposals addressed in the Bank Premises Letters were well within these parameters. Nevertheless, in both Bank Premises Letters, the OCC supervisors of the banks involved reviewed the proposals. In both instances, the OCC supervisors concluded that the proposals were consistent with the safe and sound operations of the banks. Moreover, going forward, the OCC will continue to monitor these activities to ensure that they are conducted in a safe and sound manner.

(4) If the wind farm company involved in the deal experiences financial difficulties (and takes out a loan or several loans), who will stand at the front of the line in bankruptcy (the national bank with the 70 percent equity stake here) or the "lenders" that made traditional loans?

In bankruptcy, claims of creditors generally have priority over equity stakeholders. However, in the event of a bankruptcy of the wind energy project addressed in the Project Financing Letter, it is unlikely that there would be creditors holding substantial amounts of debt. That is, the bank has represented to the OCC that the wind energy project would be structured in a manner that the bank's equity interests would have the key characteristics of a loan and would provide substantial financing for the project. In essence, the financing provided by the bank substitutes for more traditional loans. As a result, while the LLC may have business expenses and some borrowing to meet working capital needs, there likely would be no substantial amount of other outstanding debts of the LLC that would have priority over the holders of the LLC interests, including the bank.

Moreover, the bank has represented to the OCC that the agreement governing its financing for the project would contain many of the same terms, conditions, and covenants typically found in lending and lease financing transactions, including covenants restricting the LLC from taking certain actions that could materially affect the bank's financing, such as the incurrence of indebtedness or liens. Thus, if the project does not perform as the bank projected, to the point that the LLC needs to borrow substantial additional funds, the wind energy company likely would need the bank's prior approval to do so. The bank also would be able to protect its

⁵ "CAMELS" is the acronym for the factors evaluated in the Uniform Financial Institutions Rating System developed by the Federal banking agencies (capital, asset quality, management, earnings, liquidity, and sensitivity to market risk).

interests by selling its holding, and would have the ability to force a vote to liquidate the wind energy company to minimize or avoid loss on the bank's financing.

(5) Please confirm that national banks are expressly permitted to engage in certain economic and community development investment activities by statute⁶ and also confirm that – even if the OCC reversed these rulings – it would have no impact on the applicability of this federal statute.

National banks are expressly permitted to make equity investments designed primarily to promote the public welfare. 12 U.S.C. § 24(Eleventh). While this authority is distinct from the authority upon which the Bank Premises and Project Financing Letters are based, some of the arguments leveled against the Letters – e.g., that any equity investment or real estate ownership by banks represents a breach in the wall between banking and commerce – would be equally applicable to national banks' authority under 24 (Eleventh).

Section 24(Eleventh) is a limited source of authority for national banks to hold equity interests in non-banking enterprises to promote the welfare of low- and moderate-income communities, such as real estate development projects for affordable housing, and equity investments in businesses to provide services or jobs in low- and moderate-income communities and for low- and moderate-income families.⁷ Indeed, an example of the latter use of this authority is an investment by another national bank in an ethanol plant in Sherman County, Kansas,⁸ which would present the same issues as raised in the immediately preceding question. However, this investment, made pursuant to 12 U.S.C. § 24(Eleventh) and 12 C.F.R. Part 24, is not required to be underwritten comparably to an extension of credit, or required to have the terms, conditions, and covenants typically found in lending transactions. Thus, the structure of the financing described in the Project Financing Letter would appear to present lower risk.

(6) What standard does the OCC use when deciding whether to simply issue an interpretive letter or whether to issue a notice for public comment in the Federal Register? When did this standard last change?

Like the other Federal banking agencies, the OCC does not publish requests for legal interpretations for public comment before rendering legal opinions. The OCC does make all legal interpretive letters involving significant issues available to national banks and the public by publishing them in the OCC publication "Interpretations and Actions," and by posting "Interpretations and Actions" on its website. Our policy on this was adopted in 2001. See OCC PPM 1000-15 (Sept. 5, 2001). (Copy Attached.) Under this policy, the OCC will not provide a significant interpretive opinion or decision to a national bank without also incorporating it into a

⁶ 12 U.S.C. § 24(Eleventh).

⁷ 12 C.F.R. § 24.3.

⁸ Community Development Investment Letter No. 2005-3 (July 20, 2005).

published decision.⁹ In accordance with this policy, the OCC published the three interpretive Letters that are the subject of your inquiry.

Your letter contrasts the process for the Letters with that for a 1997 application from NationsBank, N.A., for permission to sponsor the development of a building containing approximately 45 residential condominium units, that the OCC published for comment in the *Federal Register*. You ask why we did not publish for public comment the request underlying Interpretive Letter No. 1044.

The 1997 request did not involve a request for an interpretive letter. It was an application under a now-repealed regulation, former 12 C.F.R. § 5.34(f),¹⁰ to engage, through a "special operating subsidiary," in real estate development that was not permissible for its parent bank, in areas that were "adjacent to or near" bank premises locations of NationsBank. The requirement for publication of the 1997 request arose from the regulation itself; former section 5.34(f)(1) provided that "[i]f the OCC has not previously approved the proposed activity, the OCC will provide public notice and opportunity to comment on the application by publishing notice of the application in the *Federal Register*." Therefore, the language that you quote from the publication of the 1997 request – that the OCC publishes all activities not previously approved – applied only to requests under former section 5.34(f) and not to requests for interpretive letters.

Your letter notes that the OCC did not approve the 1997 request, and you question whether Interpretive Letter No. 1044 is consistent with not approving the 1997 request. The answer again hinges on the fact that the 1997 request did not involve bank premises. Simply, the nature and scope of permissible bank premises was not at issue in the 1997 application. It is useful to note here that the bank submitted an amended request a year later. This amended request did involve bank premises – a complex of office buildings, including a data processing and software development center, two employee parking garages, and employee food and service related facilities. This request was approved in Conditional Approval Letter No. 298 (Dec. 15, 1998).

(7) Where does the OCC draw the line between banking and commerce? Can the line for national banks exceed the line drawn for financial holding companies?

The OCC's interpretation of activities permissible for national banks focuses on the scope of the business of banking and activities incidental thereto, based on the authorities granted by Congress under the National Bank Act and other statutes. In other words, we do not undertake to "draw the line" between banking and commerce but rather try to apply powers that have been granted by Congress. In some respects, those powers do not include activities that are clearly

⁹ An interpretive letter involves a significant issue for this purpose if it expresses an opinion about a new issue (including a new activity), develops or applies a new theory or a new analysis of an existing law or regulatory requirement, or applies an established theory or analysis to a new set of facts that differs materially from facts that the agency has previously considered.

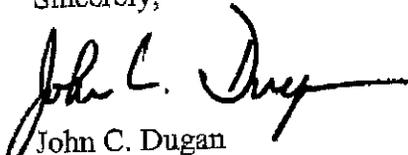
¹⁰ The Gramm-Leach-Bliley Act made it clear that operating subsidiaries of national banks could engage only in activities that are permissible for national banks to engage in directly. In response to this statute, the OCC removed section 5.34(f) from its operating subsidiary regulation effective March 11, 2000.

financial and not commercial, such as a certain securities and insurance underwriting. On the other hand, however, national banks have long been recognized to have limited authority to take direct and indirect interests in real estate, such as owning and developing real property for use in connection with the bank's own operations, and holding a limited equity interest as an integral component of a financing arrangement.¹¹

Each of the three letters involved this type of limited authority and was based upon highly specific facts, which enabled the OCC to reach narrowly-tailored conclusions. Neither the Bank Premises nor the Project Financing Letters authorized national banks to manage or operate any non-banking business. The letters were very specific that the non-banking businesses would be operated by independent third-party companies. The authority relied on in the Letters is limited in nature; the letters do not serve as precedent for allowing national banks to operate or engage in a hotel or energy business; and, therefore, the positions reflected in the Letters do not breach the separation between banking and commerce.

I appreciate this opportunity to explain our position. If I can provide you with any additional information, please let me know.

Sincerely,



John C. Dugan
Comptroller of the Currency

¹¹ While we have not analyzed the potential range of activities permissible for financial holding companies in detail, we believe that their range generally can be characterized as broader than that permitted for national banks. For example, financial holding companies under their merchant banking powers may own and control companies engaged in a broad range of activities that are generally impermissible for national banks, such as real estate development or commercial activities of any type.