TESTIMONY OF

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Before the
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
FINANCE, AND ACCOUNTABILITY
Of the
COMMITTEE ON GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES
September 27, 2006

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.
I. INTRODUCTION

Chairman Platts, Ranking Member Towns, and members of the Subcommittee, I appreciate this opportunity to appear before you today on behalf of the Office of the Comptroller of the Currency (OCC) to discuss the three interpretive letters issued by the OCC in December 2005, which you have asked the OCC to address. Two of the letters to which you refer concern situations where banks seek to enhance use of property that they already own, in connection with their own banking operations. The third letter relates to a bank’s provision of financing to an energy project. It appears that in many respects the scope and application of these letters has been misunderstood, and thus I welcome the opportunity to describe them – and their impact – fully, here today.

The decisions reflected in the letters are within the OCC’s authority and provisions of the National Bank Act. As I will describe in more detail below, the conclusions contained in the letters are quite specific, limited in scope, and within the framework of existing precedent for national banks’ activities. Since many claims have been made about what the letters do and do not authorize, let me be very clear that they do not breach the boundaries between banking and commerce, do not authorize national banks to engage in the business of real estate investment or development, have nothing to do with merchant banking, have nothing to do with allowing national banks to conduct real estate brokerage, and were carefully evaluated by OCC supervisors to assure that the activities would be consistent with the safe and sound operations of the banks involved.

Because of the limited and specific nature of the activities addressed in the letters, the banks involved do not have dual roles that could present conflicts of interest, nor do the letters set new precedent that will lead to greater participation by national banks in real estate that could potentially have larger effects on the economy. Because the OCC reviews all such proposals on
a case-by-case basis, and because our review includes participation by the supervisory officials for each bank, the conclusions in the respective letters are applicable only to the particular bank at issue. We have no evidence that the issuance of the letters has resulted in an increase in national banks seeking to engage in real estate related activities; in fact, since the letters were issued, we have received no proposals from other national banks seeking to rely on them for their own activities. Please be assured that the OCC fully recognizes the limits of national banks’ authority with respect to real estate activities and will apply those standards consistently to all national banks.

II. DISCUSSION OF THE THREE LETTERS

The limited authority of national banks to invest in real estate has long been recognized by both the courts and the OCC. This authority enables national banks to take different types of direct and indirect interests in real estate in connection with conducting their own banking business.

The following discussion describes in detail the factors the OCC relied on in reaching its decisions on the letters at issue, why the letters are consistent with the agency’s authority and supported by the National Bank Act, and why they are fully consistent with the well-recognized—and limited—parameters for national banks’ acquisition of interests in real estate.

A. Real estate/premises letters

Two of the letters, which I will call the “Bank Premises Letters,” permitted the banks to develop property they already owned, in ways that enhanced how the property served each

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Because conclusions in the letters are expressly conditioned on the specific facts presented and the capacity of the respective banks to conduct the activities in question, the letters do not generally authorize other national banks – or state banks – to engage in comparable activities. The authority of state banks to invest in real estate or engage in real estate related activities such as real estate brokerage is, in many cases, broader than the authority of national banks.
bank’s banking operations. The letters are based upon decades-old judicial precedent and OCC interpretations that expressly recognize that a national bank may hold and develop property used in connection with its own operations and lease or sell the portion of the premises that the bank does not use. This authority is subject to substantial limitations and constraints, 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, based on specific information provided by each bank, the OCC 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. As a result, the Bank Premises Letters have a limited and specific impact and do not lay a foundation for national banks’ engaging in the real estate development (or brokerage) business, and they do not breach the separation of banking and commerce.

It is useful to review the details of the two letters, since they demonstrate that the scope and implications of the letters are very limited indeed.

The situation addressed in the first letter (Interpretive Letter 1044), involved a proposal to establish a mixed-use office, hotel, and residence building on the property already owned by the bank. The proposal would expand the bank’s corporate headquarters complex, which the bank currently occupies to nearly full capacity, enabling the bank to relocate staff from more distant leased space, giving the bank additional office space for future expansion, and providing space for bank staff displaced by renovation of another of the bank’s buildings. The bank represented that it would occupy at least 22% of the premises of the new building. It also explained that the proposed mixed-use nature of the premises was necessary for the new building to be a viable project. The bank also presented evidence that the proposal represented an important part of an economic rejuvenation effort for downtown Pittsburgh, since the new premises—with their
specific combination of office, hotel and residential space\textsuperscript{2}—would be replacing rundown, dilapidated buildings that currently occupy the lots to be developed.

The second letter (Interpretive Letter 1045), addressed the establishment of a hotel facility, also on property already owned by the bank and also adjacent to the bank’s corporate headquarters in downtown Charlotte. The bank represented that it would use more than 50% of the occupied rooms to lodge out-of-area bank employees, bank directors, vendors, shareholders, customers and others who were visitors on bank-related business. The provision of lodging for out-of-area visitors and doing so in a convenient and cost-effective manner provided legitimate business reasons for the proposal. The bank also supported this proposal as an enhancement to the downtown area, anticipating that the hotel, to be built on a site currently used as a parking lot, would contribute to new businesses and new jobs at the site and in its vicinity.

Our conclusion in both cases was based on national banks’ authority to acquire and develop bank premises under 12 U.S.C. § 29. That section provides that a national bank may purchase, hold, and convey such real estate “as shall be necessary for its accommodation in the transaction of its business.”

In applying this standard, the courts and the OCC have recognized that bank premises can take different forms, such as office buildings, parking, storage, and, as here, lodging. The courts also have long recognized the principle that it is appropriate for a national bank to maximize the utility of its banking premises by leasing or selling the portion of the premises. For example, in Brown v. Schleier, 118 F. 981, 984 (8\textsuperscript{th} Cir. 1902), aff’d, 194 U.S. 18 (1904), the court stated:

If the land which [a national bank] purchases or leases for the accommodation of its business is very valuable, it should be accorded the same rights that belong to other landowners of improving it in a way that will yield the largest income, lessen its own

\textsuperscript{2}The bank demonstrated that, in order to establish required office space in an economically feasible manner, it needed to sell off a small number of residential condominiums. The bank showed that residential condominiums are becoming a common addition to downtown mixed-use office construction and that the number of condominiums it proposed were readily marketable – by an unrelated real estate broker – thus the bank would not retain that portion of the property.
rent, and render that part of its funds which are invested in realty most productive. There is nothing, we think, in the national bank act, when rightly construed, which precludes national banks, so long as they act in good faith, from pursuing the policy above outlined.

For decades—indeed, for over 100 years—courts have recognized Brown as one of the leading, if not the leading, case on the authority of national banks to establish and utilize bank premises. 3

The Brown case also contains important limiting principles that have long been recognized by the OCC and the courts. The acquisition of real estate or establishment of bank facilities must be conducted in good faith in furtherance of a bank’s banking operations, and not as a real estate development business. The burden is on the bank to demonstrate a legitimate business reason based on accommodating its banking business operations for acquiring and/or developing the property for the projected use. As one measure of good faith use of the premises for banking purposes, the courts and the OCC look to the percentage of use or occupancy of property in conjunction with the bank’s business. Finally, the investment must not be speculative or motivated by realizing a gain on appreciation of the real estate property value.

OCC interpretations, including these Bank Premises Letters, have recognized these substantial limitations and constraints.

The following chart summarizes precedent and OCC interpretations involving the sale or lease of excess bank premises. The percentage of bank occupancy or use generally has varied between 15% and 50%, with the excess space in the premises available for use by third-parties.

# Judicial and OCC Precedents Addressing National Banks' Authority to Lease Excess Bank Premises to Third-Parties

<table>
<thead>
<tr>
<th>Citation</th>
<th>Date</th>
<th>Holding</th>
<th>% Occupancy by National Bank (if applicable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interpretive Letter (available in Lexis-Nexis)</td>
<td>December 16, 1991</td>
<td>National bank may lease portion of storage facility on bank premises to unrelated third-party</td>
<td>50.0%</td>
</tr>
<tr>
<td>Interpretive Letter (available in Lexis-Nexis)</td>
<td>March 10, 1994</td>
<td>National bank may add space to two existing bank buildings and lease all new space to third-parties</td>
<td>40.0%</td>
</tr>
<tr>
<td>Interpretive Letter No. 1045</td>
<td>December 5, 2005</td>
<td>National bank may establish hotel to provide lodging for out-of-area staff, customers, and vendors, and lease excess space to third-parties</td>
<td>37.5%</td>
</tr>
<tr>
<td>Conditional Approval No. 298</td>
<td>December 15, 1998</td>
<td>National bank may establish office complex and parking facilities to provide office space for bank employees</td>
<td>25.0%</td>
</tr>
<tr>
<td>Interpretive Letter No. 1044</td>
<td>December 5, 2005</td>
<td>National bank may establish mixed-use building to provide office space for bank employees and to provide lodging for out-of-area staff, customers, and vendors, and lease excess space to third-parties</td>
<td>22.0%</td>
</tr>
<tr>
<td>Interpretive Letter No. 1034</td>
<td>April 1, 2005</td>
<td>National bank may establish two office building complex to provide office space for bank employees, and lease excess space to third-parties</td>
<td>22.0%</td>
</tr>
<tr>
<td><em>Wirtz v. First Nat'l Bank &amp; Trust Co.</em>, 365 F.2d 641 (10th Cir. 1966)</td>
<td>August 30, 1966</td>
<td>National bank may occupy percentage of office complex and lease remaining space to third-parties</td>
<td>20.7%</td>
</tr>
<tr>
<td><em>Wingert v. First Nat'l Bank</em>, 175 F. 739 (4th Cir. 1909), appeal dismissed, 223 U.S. 670, 672 (1912)</td>
<td>December 16, 1909</td>
<td>National bank has authority to tear down bank building and construct new six story office building in which bank will occupy only first floor, and lease excess space to third-parties</td>
<td>16.7%</td>
</tr>
<tr>
<td>Interpretive Letter (unpublished)</td>
<td>January 29, 1981</td>
<td>National bank may occupy percentage of office complex and lease remaining space to third-parties</td>
<td>15.0%</td>
</tr>
<tr>
<td>Interpretive Letter (available in Lexis-Nexis)</td>
<td>July 24, 1987</td>
<td>National bank may occupy small percentage of new office building constructed adjacent to bank's headquarter's building, with potential future expansion into larger percentage of new building; excess space leased to third-parties</td>
<td>5.0%</td>
</tr>
</tbody>
</table>

## Additional Bank Premises Precedent That Do Not Discuss a Specific Percentage Occupancy

### Brown v. Schleier, 118 F. 981 (8th Cir. 1902), aff'd, 194 U.S. 18 (1904)

- National Bank Act does not preclude a national bank, acting in good faith, from maximizing the utility of its banking premises by leasing excess bank premises to third-parties

### Interpretive Letter No. 2

- November 10, 1902
- National bank may own apartment in Los Angeles for use by its CEO who maintains his primary residence elsewhere

### Interpretive Letter No. 274

- December 13, 1977
- National bank may lease lobby space to variety of third-parties

### Interpretive Letter (available in Lexis-Nexis)

- December 2, 1983
- National bank may lease lobby space to variety of third-parties

### Interpretive Letter (available in Lexis-Nexis)

- August 14, 1985
- National bank authorized to develop portion of new bank premises building as office condominiums and sell the condominiums

### Interpretive Letter (available in Lexis-Nexis)

- June 24, 1992
- National bank may purchase building to house its retail brokerage business, and lease building to third-party broker which will have dual employees with the bank

### Interpretive Letter No. 1042

- January 21, 1993
- National bank may hold condominium for use of out-of-area visitors

### Interpretive Letter (available in Lexis-Nexis)

- May 6, 1993
- National bank may accept contribution of real property for future bank premises from its holding company

### Interpretive Letter No. 630

- May 11, 1993
- National bank may license use of space on its premises to a third party

### 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 (available in Lexis-Nexis)

- September 13, 1993
- 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 (available in Lexis-Nexis)

- February 23, 1994
- National bank may transfer vacant land it holds from OREO to future bank premises

### Interpretive Letter No. 758

- April 5, 1996
- National bank may lease portion of parkland, held as bank premises, to third-party

### Interpretive Letter (available in Lexis-Nexis)

- August 18, 1997
- National bank may dispose of unneeded leased bank premises by renewing its lease for 99 years and entering into coterminous sublease with developer

### Interpretive Letter

- December 8, 2005
- National bank may lease parcel larger than necessary in order to establish bank branch when lessor will lease only whole parcel; bank will sublease excess acreage to third-party
As the chart demonstrates, the proposals addressed in the Bank Premises Letters involve occupancy percentages well within the range of both judicial precedent and other OCC interpretations.

Under the standards described above, we found the proposals in the Bank Premises Letters to be permissible. In each letter, the bank demonstrated a legitimate business reason based on the accommodation of its banking business operations for developing the property with the projected use. In each letter, the bank’s represented level of occupancy established good faith development of bank premises in furtherance of the bank’s banking operations. In neither letter was the development of bank premises predicated on a desire to speculate in real estate property values. Finally, each proposal was reviewed thoroughly from a supervisory perspective, and no safety and soundness concerns were found.

Finally, it is important to stress that neither of these letters has anything to do with national banks’ engaging in the real estate brokerage business. The first Bank Premises letter, in fact, expressly noted that a real estate broker unrelated to the bank would be responsible for sales of the condominiums. This was one of the representations upon which the OCC relied in issuing this Interpretive Letter.

**B. Project Financing Letter**

The Project Financing Letter (Interpretive Letter 1048) involves the provision of financing to a wind energy project. The letter authorizes a bank to provide financing to a wind energy project in the form of an investment in order to allow the bank to take advantage of federal tax credits available for such projects, thereby lowering the overall financing cost of the project. The restrictions and limitations in the Project Financing 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 a speculative equity investment. In particular, unlike a traditional
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 interest 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.

A key factor in the decision to allow this financing transaction to be structured as an
equity investment was to allow the bank to capture tax benefits that were enacted by Congress to
finance 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 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, has affirmatively sought to promote.

Both the OCC and the courts have held that permissible loan-equivalent transactions can
take different and non-traditional forms in order to accommodate the demands of the market; the
economic substance of the transaction, rather than its form, guides the analysis of whether the
transaction is a permissible lending activity. The leading case on this is *M & M Leasing Corp. v.
(national banks may acquire, own, and lease automobiles and heavy equipment; when the
economic characteristics of a lease are substantially similar to a loan, the lease is deemed to be
an exercise of the bank's lending powers).

The Project Financing Letter noted its reliance on a 1994 precedent where the OCC found a transaction similar in structure to be a permissible loan notwithstanding its surface resemblance to an investment. See Interpretive Letter (November 4, 1994) (available in Lexis-Nexis) (bank provided financing to owners of natural gas leases by acquiring interest in business trust that owned working interests in the leases; acquisition of interest in trust that held leases necessary for the bank to be eligible to receive federal tax credit). 4

The alternative form of the transaction in the Project Financing Letter did not change the fundamental substance of the bank’s role as a provider of credit-equivalent financing. Other than the form of the interest the bank acquired as the vehicle to provide financing, the transaction addressed in this letter is substantially identical to a loan transaction. The bank represented that its decision whether to enter into the transaction would be based upon a full credit review of the borrower, that the proposed transaction would be made pursuant to the bank’s standard loan underwriting criteria, and that the documents governing the transaction would contain many of the same terms, conditions, and covenants typically found in lending and lease financing transactions, including representations and warranties, conditions precedent to the funding pertaining to the mitigation of risks, covenants requiring the company and other investors to provide the bank with customary financial information, and covenants restricting the company from taking certain actions.

Similar to a financing transaction, the bank would be repaid in installments over time. In fact, the form of structured financing for wind energy projects is similar to a production payment

4 Under 12 U.S.C. 24(Eleventh), national banks may provide financing for low-income housing development projects by acquiring an equity interest in limited partnerships and limited liability companies that hold and develop the properties. Ownership of the equity interests enables the banks to receive federal tax credits.
loan transaction frequently used in oil and gas lending. A production payment loan transaction is a form of lending frequently used in extending credit to the oil and gas industry. These production payment lending transactions, also called “oil/gas reserve based loans” and “oil/gas production loans,” are recognized and permitted by the federal banking agencies.5

Moreover, the transaction will be regulated and supervised as a loan. For example, as in the case of the 1994 interpretive letter (noted above), the Project Financing transaction will be subject to the lending limits of 12 U.S.C. § 84 and 12 C.F.R. Part 32.

We subsequently made clear that our legal opinion was premised upon the following characteristics of the financing and the bank’s role in the financing transaction as represented to us:

- Before advancing funds, the bank would determine creditworthiness of project.
- The creditworthiness review and determination would be made pursuant to the bank’s standard loan underwriting criteria.
- Structuring the financing as a membership investment would be essential to the availability of tax credits to the bank and thereby integral to material terms of the financing provided by the bank.
- The project’s agreement would contain many of the same terms, conditions, and covenants typically found in lending and lease financing transactions to protect the bank’s interests.
- The bank would not participate in operation of the wind energy company, production of the wind energy, nor the sale of the wind energy.

The bank would acquire approximately 70% of the equity interest in the company, and would look to distributions of revenue from the sale of electricity and the receipt of tax credits and depreciation expense for repayment of the funds advanced and its return on those funds.

The bank would not share in any appreciation in value of its interest in the wind energy company or any of the company’s real property or personal property assets.

In the event the energy company does not perform as projected (which would enable the bank to obtain repayment of the funds advanced, plus a calculated return), the bank may sell its interest in the wind energy company to minimize or avoid loss on the financing.

Alternatively, in the event the energy company does not perform as projected, the bank would have the ability to force a vote to liquidate the wind energy company to minimize or avoid loss on the financing.

At the end of the ten-year holding period, the bank would sell at book value its ownership interest in the wind energy company. It is projected that this value would be a small percentage of the bank’s original investment.⁶

III. CONCLUSION

In conclusion, I would like to assure you again that these three letters are limited and specific to the circumstances presented; they do not enable national banks to enter into the real estate investment or development business, nor do they have anything to do with real estate brokerage. Moreover, we fully appreciate the constraints the Gramm-Leach-Bliley Act placed on the ability of national banks’ financial subsidiaries to conduct certain real estate activities.

⁶ OCC Interpretive Letter No. 1048a (February 27, 2006).
We are mindful of the constraints that Congress, as part of its annual appropriations process, has placed on the joint Treasury Department/Federal Reserve Board rulemaking – to which the OCC is not a party – that would enable national banks and state member banks to conduct real estate brokerage activities using financial subsidiaries. Finally, because of the substantial limitations on the ability of national banks to deal in real estate, these particular interpretations do not undermine the longstanding boundaries between banking and commerce that apply to our nation’s banking system.

I appreciate the opportunity to appear before you today, and I would be pleased to answer any questions you may have.