Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1010
October 2004
12 CFR 7.1017

September 7, 2004

Re: Authority to Issue a Financial Warranty

Dear **[ ]**:

This letter responds to your request concerning the permissibility of the **[ ]**'s ("Bank's") issuance of a "financial warranty." As described in the request, the Bank and its wholly-owned operating subsidiary have issued certain financial warranties in connection with a specified mutual fund ("Fund"). Basically, the financial warranties guarantee that the investment structuring advice and monitoring services provided by the Bank to the Fund will perform as designed. For the reasons discussed below and based on the Bank's representations, we conclude that the described transaction and issuance of the financial warranties are permissible for the Bank and its operating subsidiary.

I. Background

Financial product providers have started marketing new types of mutual funds that offer a guaranteed return of principal plus a fixed return as long as the investor maintains the investment without any withdrawals for a specified period of time. This type of product offers investors the benefit of both capital preservation and capital appreciation, and are generally referred to as "principal protected" funds.[1]

The circumstances you describe involve a factually complex financial transaction in which the Bank, in effect, issues a financial warranty that guarantees that the investment structuring advice and asset allocation monitoring services provided by the Bank (or its subsidiary) in the creation and operation of the Fund will result in the designed return to the investors. The Fund offers a "Guaranteed Amount" representing return of principal plus a minimum annual return to investors

[1] *See generally* NASD Investor Alert, *Principal-Protected Funds—Security Has a Price* (Mar. 27, 2003). Other names used for these products include "capital preservation" or "guaranteed" funds. Some variable annuities also offer a similar principal protection feature.

who hold shares for seven years and who reinvest all dividends and distributions in additional shares of the Fund.[2] The Fund also offers the potential of positive equity market-based returns in excess of the minimum guaranteed amount depending on the performance of the Fund's investment assets. The life of the Fund is divided into three phases: an Offering Period, a Guarantee Period, and a Post-Guarantee Period.

During the Guarantee Period, the Fund's assets are allocated between equity and debt securities (primarily zero coupon U.S. government securities) according to the recommendation of a pre-determined complex model.[3] The Bank provides structuring assistance and asset allocation advice that includes the investment constraints and pre-defined triggers, as set forth in the financial warranty documentation, that would require the Fund's underlying assets to be liquidated and invested in zero-coupon bonds that mature at a preset future date upon the occurrence of certain events.[4] These controls are designed to ensure the Fund does not lose principal and provides the guaranteed return. In the event that the Fund's investment program does not produce a sufficient return to ensure that a shareholder can redeem its shares for the guaranteed amount on the maturity date, the financial warranty provides the financial result represented to investors.[5]

Specifically, you describe two back-to-back "financial warranties" that are in effect.[6] **[ ]** (" ***Op. Sub.*** "), a wholly-owned operating subsidiary of the Bank,[7] issued a financial warranty to the Fund guaranteeing that it will make up any shortfall between the "guaranteed amount" to investors on the maturity date and the Fund's then current net asset value. Second, the Bank issued to **[*Op. Sub.*]** a corresponding warranty guaranteeing its

---

[2] Accompanying your request were various exhibits related to the transaction, including the financial warranties, financial warranty agreements, performance guarantee, calculation agent agreement, and Fund prospectus (confidential treatment accorded for proprietary information, as applicable). The "Guaranteed Amount" is equal to the aggregate value of an investor's shares on the business day after the close of the offering period (adjusted for expenses and distributions) plus a minimum annual compounded return on such amount. *See* Principal Protected Plus Fund, *Prospectus* 1 ("Prospectus").

[3] *See* Prospectus at 3. The allocation will fluctuate in response to changes in the securities markets, and reflects various asset allocation methodology factors. See further discussion *infra* at 6. Within the parameters set forth in the financial warranty documentation, the investment adviser may invest the Fund's assets in securities that it selects using its own investment approach and based on its own valuation models to maximize the returns of the Fund. Shares of the Fund will not be offered during the Guarantee Period except in connection with the reimbursement of dividends and distributions.

[4] *See* Prospectus at 4, 6.

[5] *See id.* at 3.

[6] For purposes here, we refer to the "financial warranties" and the "financial warranty agreements" interchangeably.

[7] **[*Op. Sub.*]** is a **[*State*]** limited liability company that historically has held and managed certain closed-end residential mortgage loans and mortgage-backed securities. **[*Op. Sub.*]** files periodic reports, including financial statements, with the SEC under the Securities Exchange Act of 1934.

payment to **[*Op. Sub.*]** of any amounts owed by **[*Op. Sub.*]** to the Fund.[8] You represent that the Bank receives an on-going fee as described under the terms of the financial warranty agreement that reflects payment for the package of services provided by the Bank with respect to the principal protected mutual fund product, including the financial warranty.

II. Discussion

A. "Guarantees" Issued by National Banks

The Bank asserts that the financial warranty may be viewed as a permissible guarantee under interpretive ruling 12 C.F.R. § 7.1017. The OCC has long recognized the authority of national banks to issue guarantees in specific situations.[9] The case law on national bank guarantees is extensive. However, most of the cases occurred early in the twentieth century and several even earlier. The general rule oft-cited in those cases is that it is *ultra vires* for a national bank to guarantee the obligations of others, but there have been many exceptions. In particular and more recently, the OCC's interpretive ruling codifies that national bank guarantees that satisfy the "substantial interest" test are within a national bank's authority and permissible.

1. Statutory and Case Law Background

The National Bank Act itself is silent on the authority of national banks to provide guarantees.[10] There is no express power, nor any express prohibition, and views concerning any implied power are varied.[11] Significantly, the Supreme Court has not held that guarantees are *per se* impermissible for national banks. The Court has held a national bank has no authority to pledge assets to secure a private deposit.[12] On some occasions, the Court has upheld a guarantee given the specific facts under consideration.[13] In one instance, for example, the Court found the bank

---

[8] Separately, the Bank's holding company, **[ ]** Corporation, also issued a "performance guarantee" unconditionally guaranteeing **[*Op. Sub.*]**'s obligations under the financial warranty. That agreement provides added assurance to investors with respect to the overall Fund. The holding company's performance guarantee is not an obligation of the Bank. Further, the Fund's shareholders have no direct rights or claims against either **[*Op. Sub.*]** (under the terms of the financial warranty) or the holding company (under the terms of the performance guarantee). *See* Prospectus at 3.

[9] *See, e.g.,* Interpretive Letter No. 929 (Feb. 11, 2002); Interpretive Letter No. 376 (Oct. 25, 1986); Interpretive Letter No. 214 (July 23, 1981)

.

[10] 12 U.S.C. § 24(Seventh).

[11] *See, e.g., Texas & Pacific Railway. v. Potorff,* 291 U.S. 245 (1934) (court found no basis for claim that power to pledge bank's assets is necessary to deposit banking); *Cochran v. U.S.,* 157 U.S. 286 (1895) (contract of guarantee held within implied powers of a national bank).

[12] *See, e.g., Texas & Pacific Railway. v. Potorff,* 291 U.S. 245 (1934).

[13] *See, e.g., First Nat'l Bank of Aiken v. Mott Iron Works,* 258 U.S. 240 (1922) (declining to void a bank's guarantee of contract performance, and holding bank liable since it received the benefit of the guarantee); *Citizens Central Nat'l Bank v. Appleton,* 216 U.S. 196 (1910) (declining to void one national bank's guarantee to another bank, but deciding based on a theory of implied contract); *Cochran v. U.S.,* 157 U.S. 286 (1895) (contract of guarantee held

liable on a guarantee and explained: "the distinction between recovery on the guaranty, as having been necessarily incidental to the business of banking, and a recovery of the amount received by petitioner [the iron works company] on account of the guaranty, becomes purely formal."[14] Here the bank in order to enable the company to complete its contract, and thereby repay the advances the bank had made, gave the questioned guarantee.

Lower courts have tended to over-generalize these cases, however, in stating that national banks may not provide guarantees. In four leading cases from different circuits, the courts have explained a national bank's powers with respect to various situations involving guarantees, including a pure and simple guarantee, a guarantee incidental to another authorized banking activity, letters of credit ("in essence only guarantees," as stated by one court), and other agreements that may amount to a guarantee.[15] In sum, a reading of those cases along with the Supreme Court cases supports the conclusion that an agreement that is effectively a guarantee is permissible for a national bank if certain factors are present.

2. OCC Interpretive Ruling and Other Precedent

Section 7.1017 provides in pertinent part:

> A national bank may lend its credit, bind itself as a surety to indemnify another, or otherwise become a guarantor . . . , if:
>
> (a) The bank has a substantial interest in the performance of the transaction involved (for example, the bank as fiduciary, has a sufficient interest in the faithful performance by a co-fiduciary of its duties to act as surety on the bond of such co-fiduciary).[16]

Section 7.1017(a) follows the earlier court cases and codifies a national bank's authority to guarantee an obligation of another if the national bank has a substantial interest in the

---

within implied powers of a national bank); *People's Bank v. Nat'l Bank,* 101 U.S. 181 (1879) (guarantee of notes held within powers of a national bank when the transaction was in substance an "indorsement").

[14] *See First Nat'l Bank of Aiken v. Mott Iron Works,* 258 U.S. at 241.

[15] *See, e.g., Dunn v. McCoy,* 113 F.2d 587 (9th Cir. 1940) (courts may enforce guarantees entered into by banks for furtherance of their own rights or as an incident to the transaction of their own business, but banks may not guarantee the business accounts of their customers); *Kimen v. Atlas Exchange Nat'l Bank*, 92 F.2d 615 (7th Cir. 1937) (court invalidated bank sale of bonds to a customer and simultaneous guarantee to repurchase the bonds noting the risks of contingent liabilities that lack any definitive amount or timeframe); *Border Nat'l Bank v. American Nat'l Bank*, 282 F. 73 (5th Cir. 1922) (court upheld as a letter of credit, rather than an impermissible guarantee, an agreement covering the purchase and shipment of 200 tons of sugar); *Bowen v. Needles Nat'l Bank,* 94 F. 925 (9th Cir. 1899), *cert. denied,* 176 U.S. 682 (1900) (court invalidated bank guarantee of payment of third party's checks as an *ultra vires* contract).

[16] 12 C.F.R. § 7.1017(a). Other provisions in the regulation are not applicable here. Prior to 1996, this regulation was numbered 12 C.F.R. § 7.7010.

transaction, i.e., when the guarantee is for the bank's own benefit or in furtherance of its interests.[17]

The OCC has explained that a bank may provide a guarantee if the guarantee qualifies as "incidental" or "convenient" or "useful" to the performance of the business of banking under 12 U.S.C. § 24(Seventh).[18] A "substantial interest" exists if the guarantee provided by the bank is "incidental" to another of its authorized activities.[19] The nexus between the bank permissible transaction and the guarantee provides the substantial interest for the bank.[20] For example, the interest of a bank in assuring the financial performance of a co-fiduciary constitutes a sufficient interest to justify the issuance of a guarantee.[21] That relationship is analogous to the interest of a bank in assuring the financial performance of an affiliate, including a subsidiary corporation. However, the OCC has indicated that issuing a guarantee merely to maintain a customer relationship or just to receive a fee would not satisfy the requisite substantial interest.[22]

3. Bank May Issue A Financial Warranty As a Guarantee In Connection with Its Involvement and Interest in the Structuring and Operation of the Fund

Here the Bank's involvement and interest in the structuring and performance of the overall Fund product satisfies section 7.1017 for the Bank to act as a guarantor. The Bank represents its role as the financial product consultant and adviser of the principal protected product, which includes a guarantee aspect denoted as the "financial warranty." The Bank has provided detailed financial advice and consultation with respect to the creation and implementation of the Fund. This includes the development, analysis, and counseling related to structuring the investment program, the allocation models, and the defeasance triggers that are integral to the Fund's

---

[17] *See, e.g., First Nat'l Bank of Aiken v. Mott Iron Works,* 258 U.S. 240 (1922); *Dunn v. McCoy,* 113 F.2d 587 (9th Cir. 1940); *Southern Exchange Bank v. First Nat'l Bank*, 141 S.E. 323 (Ga. App. 1928).

[18] *See, e.g.,* Interpretive Letter No. 929 (Feb. 11, 2002) (bank's provision of a default fund contribution/guarantee was incidental to bank's clearing and execution activities and satisfied the substantial interest needed for issuance of a guarantee); Interpretive Letter No. 542 (Feb. 6, 1991) (guaranteeing loans of foreign bank subsidiary fell within a guarantee issued for the bank's own benefit, and thus viewed as incidental to the business of banking).

[19] *See, e.g., Dunn v. McCoy,* 113 F.2d 587 (9th Cir. 1940) (bank guarantee enforceable in furtherance of bank's own rights); Interpretive Letter No. 376 (Oct. 25, 1986) (national bank's guarantee of third party securities borrowers' conduct was incidental to bank's securities lending program and constituted a sufficient substantial interest; guarantee was merely a minor part of a much larger package of banking services).

[20] *See, e.g.,* Interpretive Letter No. 218 (Sept. 26, 1981), (national bank may issue a bill of lading guarantee due to its substantial interest in facilitating liquidation of goods after the previous issuance of a letter of credit); Interpretive Letter No. 177 (Jan. 14, 1981) (national bank may in direct deposit pension fund program provide for guarantee/ reimbursement of third party payors in the event a customer was not entitled to the payment as consistent with a bank's incidental powers).

[21] *See* 12 C.F.R. § 7.1017(a); *see also* OCC Interpretive Letter No. 57 (Oct. 5, 1978).

[22] *See, e.g.,* Interpretive Letter No. 376 (Oct. 25,1986) (substantial interest cannot be interest created by the guarantee itself).

financial structure and performance[23] as well as on-going financial counseling and monitoring related to the Fund's actual operation.[24] The Bank also has provided an evaluation of the financial risks and related considerations involved in this type of product.[25] It is well established that national banks may provide those types of activities.[26]

The Bank's ability to sell the larger package of banking activities associated with the "principal protected" model to independent mutual funds is enhanced by the Bank's ability to provide the protection related to the Fund's ultimate performance. One of the essential characteristics of the principal protected mutual fund is a pledge of a minimum guaranteed financial performance for a set time. The guarantee of the return of principal to the shareholders (i.e., the "Guaranteed Amount") is the same as the Bank's exposure on the financial warranty. Functionally, the financial warranty operates to guarantee payment only if the Fund itself fails to meet a certain expected financial result.[27] In this context then, if the package of banking services provided by the Bank works as designed, the guarantee should be moot, i.e., the guarantee is to backstop a financial result that the Bank has designed Hence, the Bank provides the financial warranty as a guarantee that the Bank's models, structuring advice, and asset allocations work as represented to the Fund and its investors.

---

[23] Numerous factors are integral to the operation of the Fund. "Generally, the model allocates the Fund's assets to zero coupon U.S. government securities with value on the maturity date, together with a discounted value of the Fund's other assets, sufficient to fund the Guaranteed Amount, with the remainder of the Fund's assets being allocated between equity securities and debt securities based upon the outlook for, and volatility of, the equity markets." Prospectus at 4. Factors reflected in the asset allocation methodology include: (1) the market value of the Fund's assets as compared to the aggregate "guaranteed amount;" (2) the prevailing level of interest rates; (3) equity market volatility; and (4) the length of time remaining until the maturity date. *Id.*

[24] The Bank represents its continuing role with respect to the Fund's operation includes comparisons and evaluations of financial performance to the designated structure, and recommended adjustments as necessary. The Bank performs this daily monitoring role using its technology and risk management infrastructure to evaluate the Fund's compliance with the parameters set forth within the financial warranty agreements. The Bank itself or the Bank's agents through an affiliate may perform those activities. You represent that the Bank has no other specific contract pertaining to those activities and receives no separate fee. The Bank is paid an on-going fee as described under the terms of the warranty agreement.

[25] The Bank's exposure from the principal protected Fund product is small. The Bank represents that because of the nature of the investments the credit risk is virtually zero and the market risk is minimized to a low level within certain defined parameters.

[26] National banks have long provided financial advice and counseling under the authority of 12 U.S.C. § 24(Seventh). *See, e.g.,* Conditional Approval No. 289 (Oct. 2, 1998); Interpretive Letter No. 725 (May 10, 1996); Interpretive Letter No. 516 (Jul. 12, 1990); Interpretive Letter No. 367 (Aug. 19, 1986); Interpretive Letter No. 137 (Dec. 27, 1979). Those activities include investment portfolio management, business advisory services, financial planning, investment recommendations, and analyses of economic trends, among other similar financial activities.

[27] Essentially the Bank as issuer of the financial warranty is secondarily liable for the payment of a certain level of performance by the Fund. This is consistent with a contract of guaranty where the guaranty creates a secondary liability on the pre-existing obligation of another – to pay in the event that the other does not. *See e.g., American Ins. Ass'n v. Clarke,* 865 F.2d 278 (D.C. Cir. 1988), *vacated in part on other grounds,* 865 F.2d 287 (1989).

Under these circumstances, the guarantee issued by the Bank in the form of a financial warranty satisfies the requisite substantial interest set forth in section 7.1017(a). The Bank's interest in the financial warranty advances the Bank's own interest in providing financial activities related to principal protected funds and is not merely an interest created by the guarantee itself. Accordingly, subject to satisfying the safety and soundness considerations discussed below, the Bank may provide the financial warranty as a guarantee under the circumstances represented by the Bank.[28]

B. Safety and Soundness Considerations

For the Bank to permissibly engage in the issuance of the financial warranty, consideration of the Bank's risk management procedures and internal controls must reflect that the activities are conducted safely and soundly. The nature of this complex financial transaction requires sophisticated risk measurement and management capacities on the part of the bank and qualified personnel in order for the activity to actually function as described and to operate in a safe and sound manner. In other issuances, and as applicable here, the OCC has indicated an effective risk measurement and management process includes appropriate oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective and independent risk control function that oversees and ensures the appropriateness of the risk management process.[29]

Our conclusion regarding legal permissibility therefore is subject to OCC Supervisory staff concluding that the Bank has such risk measurement and management processes in effect with respect to its financial warranty product.[30] Absent such a showing by the Bank, the product might not function in the manner that is the predicate for the legal conclusions discussed herein. Finally, going forward, the OCC requires the Bank to seek a regulatory capital opinion concerning treatment of the financial warranties for capital purposes.

---

[28] Likewise, the corresponding financial warranty issued by the Bank's wholly-owned operating subsidiary is an integral part of the overall transaction and is authorized on the same basis. Other legal authorities, such as the independent undertaking regulation (12 C.F.R. § 7.1016) or a derivatives theory also may support this type of activity, but it is unnecessary to analyze those alternatives here since we find the activity permissible under the guarantee theory.

[29] *See e.g.*, OCC Bulletin 2004-20, *Risk Management of New, Expanded, or Modified Bank Products and Services* (May 10, 2004); *Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities*, 69 Fed. Reg. 28980 (May 19, 2004) (proposed guidance); OCC Bulletin 1999-2, *Risk Management of Financial Derivatives and Bank Trading Activities* (1999); Comptroller's Handbook, *Risk Management of Financial Derivatives* (1997); BC-277, *Risk Management of Financial Derivatives* (1993).

[30] In the absence of particular facts and supervisory knowledge of an individual institution, the OCC would not be able to opine whether a specific financial warranty transaction would be permissible for a specific bank.

III. Conclusion

Accordingly, based on the described facts and circumstances of this transaction, for the reasons discussed, and subject to the Supervisory staff conclusions described above, we conclude that the Bank's and its operating subsidiary's issuance of the financial warranties in connection with the principal protected Fund are legally permissible under 12 C.F.R. § 7.1017. If you have any questions concerning this matter, please contact Suzette H. Greco, Special Counsel, Securities & Corporate Practices Division, at 202/874-5210.

Sincerely,

/s/ *Julie L. Williams*

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel