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Thomas M. Stevens, CRB, CRS, GRI
President

January 27, 2006

The Honorable John C. Dugan
Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Dear Comptroller Dugan:

On behalf of the more than 1.2 million members of the National Association of REALTORS® (NAR), I am writing about recent rulings of the Office of the Comptroller of the Currency (OCC) that expand the powers of national banks to engage in real estate development and merchant banking and, in our opinion, are inconsistent with Federal statute, OCC regulations, and OCC precedents.

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association, including NAR's five commercial real estate affiliates. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,500 local associations or boards, and 54 state and territory associations of REALTORS®.

I. INTRODUCTION

In December 2005, the OCC announced it was authorizing national banks to invest in real estate projects involving the development of office buildings, hotels, residential condominiums and windmill farms.[1] In our opinion, the OCC actions represent a marked departure from what is permitted by the National Bank Act, the OCC's regulations and previous OCC rulings regarding the types of real estate activities in which national banks may engage. The new rulings represent the OCC's continued efforts to dramatically expand the real estate powers of national banks. You disagree and issued a statement that there seems to be a "fundamental misunderstanding" of the effect of the letters.[2] Despite your statements to the contrary, numerous banking experts see your actions as a significant expansion of real estate

[1] OCC Interpretive Letter No. 1044 (December 5, 2005); OCC Interpretive Letter No. 1045 (December 5, 2005); OCC Interpretive Letter No. 1048 (December 21, 2005).
[2] OCC News Release 2006-3 (January 11, 2006). "Dugan: OCC Didn't Widen Realty Powers," *American Banker* (January 12, 2006).

powers of national banks.[3] Indeed, two former Comptrollers, Eugene Ludwig and John D. Hawke, have publicly acknowledged that the OCC letters move the bar.[4]

OCC's actions have set in motion a process that will inevitably lead to national banks becoming actively involved in real estate development and brokerage activities. Such activities will markedly increase the risk exposure of national banks and threaten the safety and soundness of the banking system. Moreover, permitting national banks to engage in real estate activities undermines the longstanding, Congressionally-mandated separation between banking and commerce. These same concerns, by the way, apply to state banks with "wild card" authority to engage in activities permitted for national banks.

II. BACKGROUND

A. The National Bank Act

The National Bank Act imposes strict limits on the ability of national banks to own real estate.[5] Specifically, national banks may purchase, hold and convey real estate under the following narrow circumstances "and for no others":

- Property necessary for accommodating its business.
- Property mortgaged to the bank as security for debts previously contracted.
- Property conveyed to the bank in satisfaction of debts previously contracted.
- Property purchased at sales under judgments, decrees or mortgages held by the bank or purchases to secure debts owed to the bank.

National banks are required to dispose of real estate acquired in satisfaction of debts owed to it by customers within five years.[6] National banks are also permitted to invest in bank premises in an amount up to the bank's capital.[7] The Supreme Court has long held that the purpose of these restrictions is to deter national banks from "embarking in hazardous real estate transactions," ensure the maintenance of liquidity and prohibit the accumulation of large amounts of property by national banks.[8]

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[3] "Banks Might Widen Real-Estate Role," *Wall Street Journal* (January 9, 2006); "OCC Moved the Line on Realty in UBOC Letter," *American Banker* (January 11, 2006). "Tough Enforcement Belie Effort to Expand Bank Powers," *Financial Services Policy Bulletin*, Stanford Washington Research Group (January 25, 2006). "Will Banks Become Land Developers?" CNN Money (January 9, 2006) at http://money.cnn.com/2006/01/09/news/companies/banks_real_estate.

[4] "In Focus: Firm, But Not Specific, On Banks in Real Estate," *American Banker* (January 23, 2006).

[5] 12 U.S.C. § 29.

[6] *Id*. With OCC approval, the five year holding period may be extended for up to an additional five years if the bank has made a good faith attempt to dispose of the property or if disposal within the five year period would be detrimental to the bank.

[7] 12 U.S.C. § 371d. The limit is increased to 150 per cent of capital for banks that are "well-capitalized" and possess a high CAMEL (*i.e.*, supervisory) rating of 1 or 2.

[8] *Union National Bank v. Matthews*, 98 U.S. 621, 626 (1879).

B. OCC Regulations

The OCC has adopted several regulations that address the power of national banks to purchase or hold interests in real estate. OCC regulations circumscribe the nature and circumstances under which national banks may extend credit secured by liens on real property.[9] Generally, a national bank may lend to a third party and take as security for the loan a lien on or interest in the real estate.[10] OCC regulations define a "loan or extension of credit" as "a bank's direct or indirect advance of funds to or on behalf of a borrower based on an obligation of the borrower to repay the funds or repayable from specific property pledged by or on behalf of the borrower."[11] The OCC's letter permitting a national bank to invest in windmill farms does not comport with these regulations.

The OCC has also adopted regulations concerning national bank investment in real estate that is necessary for the transaction of its business.[12] Accordingly, a national bank may invest in the following types of real estate:

- Real estate that the bank occupies as bank premises.
- Real estate acquired and intended, in good faith, for use in future expansion.
- Parking facilities.
- Residential property for the use of bank officers and employees who are:
    - located in remote areas where suitable housing at reasonable price is not readily available; or
    - temporarily assigned to a foreign country, including foreign nationals temporarily assigned to the U.S.
- Property for use of bank officers, employees, or customers, or for the temporary lodging of such persons in areas where suitable commercial lodging is not readily available, provided that the purchase and operation of the property qualifies as a deductible business expense for Federal tax purposes.[13]

OCC regulations also set out the procedures governing OCC review of applications from national banks to invest in bank premises.[14] The regulations define bank premises as:

- Premises that are owned and occupied (or to be occupied, if under construction) by the bank or its subsidiaries.
- Capitalized leases and leasehold improvements, vaults, and fixed machinery and equipment.
- Remodeling costs to existing premises.
- Real estate acquired and intended, in good faith, for use in future expansion.
- Parking facilities that are used by customers or employees of the bank, its branches, and its consolidated subsidiaries.[15]

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[9] 12 C.F.R. Part 34.
[10] 12 C.F.R. § 34.3(a).
[11] 12 C.F.R. § 32.2(k).
[12] 12 C.F.R. § 7.1000.
[13] 12 C.F.R. § 7.1000(a)(2)(i)-(v).
[14] 12 C.F.R. § 5.37.
[15] 12 C.F.R. § 5.37(c).

A review of the OCC's December 2005 letters permitting national banks to invest in office buildings, hotels and residential condominiums indicates that such facilities fall well outside what the OCC has traditionally regarded as "bank premises."

III. ANALYSIS

A. The OCC's December Bank Premises Rulings Conflict with the National Bank Act, OCC Regulations and Prior OCC Rulings

The OCC has issued numerous rulings regarding the authority of national banks to acquire real estate for use in the banking business. The OCC has consistently stated that "[t]he key point is that a bank must hold the property for banking premises and not for real estate speculation."[16] The OCC's December 2005 letters violate this principle.

1. The Hotel Letter

In December 2005, the OCC concluded that a national bank was permitted to develop a hotel to provide lodging for the bank's out of area visitors under the guise of "bank premises."[17] The bank stated that its purpose in establishing the hotel was to reduce its annual lodging expense for bank visitors and to "improve the overall quality of experience" for bank visitors. The hotel would have approximately 150 rooms, and the bank indicated that approximately 37.5 percent of the rooms would be used by persons related to the bank's business. The Hotel Letter suggests that this level of usage exceeds what has been "expressly permitted in the case law on bank premises."[18] A review of the cases cited reveals that the holdings did not involve the banks' level of usage of bank premises. In the first case, a national bank's shareholder alleged that the bank's tearing down of its existing office building and the erection of a new six story office building at the same location was *ultra vires*.[19] The court stated:

> It should be noticed that this is not the case of a national bank about to purchase real estate for the purpose of erecting thereon a six-story building as a business enterprise. In the present case the lot of ground has belonged to the bank since its organization . . . It is therefore simply a question whether or not the bank which is and has been for many years the rightful owner of a lot of ground improved by its bank building can alter and enlarge the improvement on it so as to furnish better accommodation for the business of the bank . . .[20]

The Hotel Letter involves the development of a hotel, which of course is far removed than the erection of an office building on property which was long owned by the bank and on

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[16] OCC Interpretive Letter No. 758 at 4 (April 5, 1996).
[17] OCC Interpretive Letter No. 1045 (December 5, 2005) (Hotel Letter).
[18] Hotel Letter at 3.
[19] *Wingert v. First National Bank of Hagerstown*, 175 F. 739 (4th Cir. 1909).
[20] *Wingert* at 741.

which the bank's building was which already located. Accordingly, *Wingert* does not support the OCC's conclusion.

The issue of the second case was whether the minimum wage requirements of the Fair Labor Standards Act covered employees of a national bank's subsidiary which operated and maintained a building complex owned by the national bank.[21] The court held that the employees of the operating subsidiary were covered by the act because the subsidiary and the bank were engaged in a common enterprise and the subsidiary's activities were related to the bank's operations.[22] While the case stated that the bank occupied 20.7 percent of the total space, contrary to the OCC's statement, there is nothing in the ruling to suggest that it was "recognizing" the bank's authority to occupy the space and lease the remaining space. Accordingly, the OCC's conclusion is not supported by case law.

The OCC's regulation regarding ownership of property provides that a national bank may invest in real estate if the property is used for temporary lodging in areas where suitable commercial lodging is not readily available.[23] The Hotel Letter is devoid of any indication that suitable commercial lodging is not readily available in the area. Indeed, the only justification the OCC gives is that the hotel will reduce the bank's lodging expense for bank visitors and "improve the overall quality of experience" for bank visitors. This rationale hardly justifies the OCC ignoring its own regulation. Accordingly, the Hotel Letter is inconsistent with, and contrary to, law and regulation.

The OCC rationalizes the Hotel Letter by contending that the limitation set forth in its real estate investment regulation is only an example. If the carefully constructed regulatory restriction is simply an example that may be conveniently ignored by the OCC and national banks, what then is the purpose of the limitation in existing law? If the OCC desires to permit national banks to invest in hotels, it must, in accordance with the Administrative Procedure Act,[24] solicit public comment on a proposed change to its existing rule rather than expand national bank real estate investment powers by administrative fiat.

2. The Condominium Letter

In December 2005, the OCC also determined that a national bank was permitted to develop a mixed-use building that would provide 12 floors of office space for the bank's use, ground floor retail and restaurant space, five floors of hotel space (158 rooms) and four floors of condominiums (32 units).[25] The bank indicated that, over time, it expects to occupy approximately 25 percent of available office space and 10 percent of the hotel rooms. After developing the condominiums, the bank would sell them. The OCC's decision is inconsistent with prior OCC decisions concerning the level of bank occupancy needed to qualify as bank premises. Furthermore, for the reasons indicated above, permitting the national bank to invest in a hotel without determining whether suitable commercial lodging is readily available in the area

[21] *Wirtz v. First National Bank and Trust Company*, 365 F.2d 641 (10th Cir. 1966).
[22] *Wirtz* at 643-644.
[23] 12 C.F.R. § 7.1000(a)(2)(v).
[24] 5 U.S.C. § 553.
[25] OCC Interpretive Letter No. 1044 (December 5, 2005) (Condominium Letter).

conflicts with the OCC's own rules. Finally, there is no basis in law or regulation that permits a national bank to develop and own residential condominiums for sale to the public.

In 1998, the OCC approved an application by a national bank to establish an operating subsidiary to acquire an interest in a limited liability company which would acquire, develop and manage real estate for use as bank premises.[26] The bank stated that it would occupy at least 75 percent of the proposed 900,000 square foot complex, which consisted of 900,000 square feet of office space in three buildings and two employee parking garages with 2,000 spaces. Another 15 percent of the office space was to be occupied by bank-dedicated service providers. The OCC indicated that "[a]t all times, however, the Bank will occupy a substantial portion of each office building in the Complex."[27] To underscore the importance of this aspect of the proposal, the OCC emphasized that "[t]he Bank is expected to remain, at all times, a substantial tenant within the Complex."[28] The applicant also indicated that a portion of the property would be sold to a third party who would develop it into residential units; the bank was not involved in the development of the residential units and would not own or manage them.[29] Although the ruling did not indicate what constitutes "substantial" occupancy, it is readily apparent from the occupancy percentages referred to in the letter that traditionally the OCC has regarded the minimum occupancy level to be much higher than the 25 percent indicated in the Condominium Letter. In this regard, the Condominium Letter refers to an OCC decision in which the bank would occupy only 22 percent of the total space (office and parking) for support of its determination that a 25 percent occupancy level is sufficient to meet the requirement for bank premises.[30] The OCC fails to mention that the letter relied upon was issued in April 2005[31] and accordingly, cannot be regarded as longstanding OCC precedent.

The OCC also states that revenue from the bank's development of the hotel and residential condominiums is important to the success of the bank's financing of the project. The OCC points to a prior ruling in which it permitted a national bank to develop a bank premises building and sell excess space as office condominiums.[32] The sale of excess office space can hardly be equated with the development and sale of residential condominiums, which are in no way related to the business of a national bank. By relying upon the rubric that the development of residential condominiums promotes the "economic viability" of the project, the OCC has opened the door to permitting national banks to engage in <u>any</u> type of commercial or residential real estate development so long as the bank can contend that such activities promote the economic success of the project.

B. The Windmill Letter Conflicts With Longstanding OCC Precedents Regarding What Constitutes Bank Lending

In a letter to counsel for Union Bank of California, N.A. (the "Windmill Letter"), the OCC considered the bank's request to make an equity investment in approximately 70 percent of

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[26] OCC Conditional Approval No. 298 (December 15, 1998). 1998 OCC Ltr. LEXIS 96.
[27] *Id.* at fn. 3.
[28] *Id.* at 6.
[29] *Id.* at fn. 2.
[30] Condominium Letter at 4.
[31] OCC Interpretive Letter No. 1034 (April 1, 2005).
[32] OCC Interpretive Letter dated August 14, 1985.

a limited liability company (LLC) that would operate a wind energy project.[33] The LLC would purchase wind turbines and interests in real estate needed to generate electricity. The OCC indicated that the transaction was structured as an equity investment rather than a loan in order to take advantage of federal renewable electricity production tax credits. The bank would be repaid in installments consisting of income provided from revenues produced by the project and by the tax credits. The OCC concluded that the equity investment was permissible because it was the functional equivalent of bank financing.

To justify the equity investment, the OCC relied upon a 1999 ruling in which it permitted a national bank to establish an operating subsidiary to invest in an entity that would rehabilitate historic structures in order to take advantage of federal rehabilitation tax credits.[34] The OCC indicated that, in substance, the transaction was the provision of construction financing which would be repaid from operating income and through tax credits. What the OCC failed to mention is that in the 1999 Ruling the bank provided construction financing and used the tax credits to reduce the origination fee and interest rate charged on the loan. Moreover, upon completion of the project, the construction loans would be converted to permanent loans. In contrast, the Windmill Letter does not involve a loan by the bank. The bank would make only the equity investment. The transaction described in the Windmill Letter is substantially different than the facts presented in the 1999 Ruling. Accordingly, the 1999 Ruling does not support the OCC's conclusion in the Windmill Letter. The Windmill Letter also cites a 1998 Corporate Decision as support for its conclusion. A review of that ruling reveals that the bank in that transaction also had provided financing in the form of extending actual loans to the borrowers.[35] Moreover, the ruling indicates that under the terms of the agreement between the parties, the borrower was obligated to repay the bank the amount advanced plus interest.[36] No such obligation is present in the Windmill Letter.

The OCC has long held that to be regarded as a financing, the borrower must be obligated to repay principal and repayment of principal must be contractually assured.[37]
This principle was reaffirmed in a ruling issued in 2000 in which the OCC stated that "[r]equiring the borrower to repay principal preserves the fundamental nature of the bank's activity, *i.e.*, that of a lender."[38] In addition, the borrower's obligation may not be conditioned on the profit, income or earnings of the business enterprise.[39] The Windmill Letter undermines these longstanding principles.

First, the Windmill Letter does not require the LLC to repay the bank the amount of its investment. This, of course, is inconsistent with the OCC's position reflected in longstanding rulings that to be regarded as a financing, the borrower must be obligated to repay principal. Second, the OCC indicates that the bank will receive periodic payments from the revenues

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[33] OCC Interpretive Letter No. 1048 (December 21, 2005).
[34] OCC Corporate Decision 99-07 (March 26, 1999) (1999 Ruling).
[35] Corporate Decision No. 98-17 (March 23, 1998) ("The Bank has extended credit of approximately $320,000 to a limited liability company that owns and operates oil and gas leases . . .")
[36] *Id.* at 3 ("The Bank has advanced funds to the Borrower and would receive repayment of principal plus interest.").
[37] OCC Interpretive Letter No. 244 (January 26, 1982). 1982 OCC Ltr. LEXIS 18 (1982 Ruling).
[38] OCC Corporate Decision No. 2000-02 (February 25, 2000). The decision also provides that "[i]t is necessary that the borrower be obligated to repay principal in order to preserve the nature of the underlying transaction, *i.e.*, making a loan."
[39] 1982 Ruling. at *3.

produced by the project and tax credits. This conflicts with the OCC's position, also reflected in the 1982 Ruling, that the borrower's obligation may not be conditioned on the profit, income or earnings of the business enterprise.[40] In contrast, the bank in the Windmill Letter will be paid solely from project revenues and tax credits. This represents a marked departure from prior OCC rulings.

The Windmill Letter also conflicts with other OCC precedents. For example, in 1988, the OCC considered whether a national bank could invest in a limited partnership that was organized to invest in entities that would own, operate and renovate real estate. The letter stated that while 12 U.S.C. § 29 grants national banks some limited authority to purchase, hold and convey real estate for bank premises and in a debt-previously contracted context "[t]hat limited authority does not include generally owning, operating, and renovating real estate (note that the statute provides no *de minimis* exception)."[41] The OCC rejected the bank's attempt to characterize the limited partnership interest as nothing more than the "substantial equivalent" of a secured loan with an "equity kicker."[42] For similar reasons, the OCC's attempt in the Windmill Letter to treat the bank's investment in the LLC as the equivalent of bank financing fails.

IV. CONCLUSION

A careful analysis of the OCC's three rulings issued in December 2005 reveals that they conflict with longstanding limitations on national bank real estate powers set forth in the National Bank Act and OCC regulations. Moreover, we believe the rulings are inconsistent with longstanding principles established by previous OCC rulings and interpretations. The December 2005 letters represent what many consider to be an expansion of national bank real estate investment powers, which, if left unchecked, will markedly increase the risk exposure of national banks and threaten the safety and soundness of the nation's banking system.[43] When combined with other powers, such as the ability to act as finders and to buy and sell bank and customer assets, the rulings have the potential to lead to a significant erosion of the separation between banking and commerce.

We urge the OCC to reconsider these recent rulings and, in any case, not to take any future actions that have the result of expanding bank powers to engage in real estate development.

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[40] *Id.*
[41] OCC Interpretive Letter No. 435 (June 30, 1988). 1988 OCC Ltr. LEXIS 97 at *3.
[42] *Id.* at *4.
[43] The potential threat real estate activities present to banks and the banking system was underscored recently by the OCC and the other federal banking agencies, which issued proposed guidance to banks to address concerns that certain real estate lending activities may make banks more vulnerable to cyclical commercial real estate markets. 71 *Fed. Reg.* 2302 (January 13, 2006). *See, also,* "Tighter Scrutiny Proposed on Commercial Real Estate," *American Banker* (January 11, 2006).

Our staffs have already been in communication to arrange a meeting so we may discuss our concerns in person. I understand you have agreed to meet, and I very much appreciate your willingness to discuss this important issue.

Sincerely yours,

Thomas M. Stevens
President