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Comptroller of the Currency  
Administrator of National Banks

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October 17, 1997

**Interpretive Letter #806**  
**December 1997**  
**12 U.S.C. 24 (7)**  
**12 U.S.C. 371**

Mr. Steven T. Thomas  
General Manager  
United Bank of Kuwait  
Tower 56  
126 East 56th Street  
New York, New York 10022

Dear Mr. Thomas:

This responds to your letter and subsequent telephone discussions requesting our opinion regarding whether the National Bank Act permits The United Bank of Kuwait PLC (“UBK” or “Branch”), a Federal branch located in New York, New York, to offer a residential Net Lease home finance product as part of the business of banking, pursuant to 12 U.S.C. § 24(Seventh) and 12 U.S.C. § 371. The Branch currently has an active mortgage lending business and wishes to have the flexibility to offer Net Leases to meet the special needs of its customers who adhere to the principles of Islam. The religious prescriptions of Islam or other faiths prohibit home purchasers from borrowing money where the lender charges interest and, therefore, effectively prohibit such individuals from purchasing homes by executing standard mortgages. The Branch proposes an alternative arrangement to help Islamic customers purchase residential real estate. The Branch will finance the home purchase contingent upon the Branch and the customer executing a Net Lease and Purchase Agreement. UBK argues that the economic substance of the Net Lease will be functionally equivalent to secured real estate lending. UBK further represents that its proposal satisfies accounting requirements so that the Net Lease will be characterized as financing rather than leasing. UBK anticipates that the Internal Revenue Service (“IRS”) will treat its proposal as financing rather than leasing. As discussed below, we conclude that UBK may conduct the activity based upon the facts and circumstances described herein.

**I. UBK’s Proposal**

UBK will structure the residential home financing arrangement as follows. The Lessee will contract with the Seller to buy a single family residence and will tender a down payment toward such purchase. Before funding the remainder of the purchase price, UBK and the Lessee will simultaneously enter into a Net Lease Agreement and a Purchase Agreement (collectively “the Agreements”). The Lessee will accept the property “as is” and UBK, as lessor, will make no

representations or warranties regarding the property or its suitability. Then, UBK will supply the remainder of the funds to purchase the property from the Seller under the sales contract. UBK will have “legal title” to the property. UBK will record its interest in the property in the same manner as it would record a traditional mortgage.

UBK will not purchase or maintain an inventory of properties to sell to customers. Instead, the customer will be required to find the property that he or she wishes to purchase and negotiate the terms of the purchase with the Seller. The Branch also will not serve as a real estate broker or agent.

The Net Lease will convey to the Lessee occupancy rights in and to the property for a specified number of years. The Net Lease will require that the Lessee maintain the property, and pay charges, costs and expenses attributable to the property that an owner or purchaser would ordinarily otherwise pay. Monthly lease payments will be sufficient to cover principal and interest, and pay insurance and property taxes. The Lessee will amortize the entire principal by the end of the lease term.

The Lessee will automatically become the legal owner of the property upon fulfilling the terms of the lease. Once the Lessee pays the final lease installment, the Lessee will not have to take any additional steps to acquire title to the property. The Purchase Agreement will also provide that the Lessee may acquire title to the property anytime before the expiration of the lease by prepaying the remainder of the purchase price.

In case of a material default under the lease, UBK will have remedies against the Lessee for nonpayment similar to those available to a lender on a “traditional” nonrecourse mortgage. UBK will provide notice of default to the Lessee and give the Lessee an opportunity to cure the default. If the Lessee cannot cure the default within a specified time, UBK will treat the property as if it had been acquired in foreclosure. UBK will not relet the property; instead, it will treat the property as Other Real Estate Owned (“OREO”) and sell the property in accordance with 12 U.S.C. § 29 and 12 C.F.R. Part 34.

UBK represents that the Net Lease financing program satisfies the requirements of Generally Accepted Accounting Principles and the Net Lease will be treated as financing rather than leasing. The Branch’s General Ledger would have accounts called Residential Loans and Islamic Home Finance Lease Receivables. The Branch will use the accrual methodology to account for both the conventional mortgage and the Net Lease home finance product. Although the two products will have different documentation, the monthly lease payments will be calculated in the same manner. UBK will add its margin to its cost of funds at the beginning of the lease. The London Interbank Offering Rate will be used to determine UBK’s cost of funds. UBK will then allocate lease payments to mirror the principal and interest breakdown of a conventional mortgage.

UBK also anticipates that the IRS will treat the Net Lease as financing and allow the customer to deduct the interest portion of the lease payment in the same manner as interest is deducted on traditional mortgages.

UBK initially intends to provide Net Lease financing for home purchases in [ ] states: [ ].

UBK estimates that loan demand could reach \$[ ] during the first few years. The Branch currently has approximately \$68 million in assets and expects [ ]% additional growth in 1997. UBK anticipates [ ]% annual growth thereafter. UBK has an existing mortgage lending portfolio of approximately \$[ ]. The Branch anticipates that its mortgage loan portfolio will increase to approximately \$[ ] by year-end 2001. If approved, it anticipates that the proposed Net Lease home finance product will account for approximately \$[ ] (i.e., [ ]%) of the mortgage loan portfolio. During the startup phase of the program, UBK will monitor the condition of the properties. UBK intends to have an appraiser and compliance officer as part of its staff to inspect the properties periodically. If demand for the program increases, UBK may contract with a third party to service the loans.

## II. Discussion

The International Banking Act of 1978 permits Federal Branches to engage in the business of banking under the rules, regulations, or orders that the OCC considers appropriate. Federal Branches may conduct their operations with the same rights and privileges provided to national banks under the National Bank Act. See 12 U.S.C. § 3102(b). UBK is a Federal Branch of a foreign bank and may engage in activities that the Comptroller, in his discretion, considers to be part of, or incidental to, the business of banking. See 12 C.F.R. § 28.13(a).

### A. Applicable Law

The National Bank Act provides that national banks shall have the power:

[t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes . . . .

12 U.S.C. § 24(Seventh).

The Supreme Court has held that this clause is a broad grant of power to engage in the business of banking including, but not limited to, the five specifically recited powers and the business of banking as a whole. See NationsBank of North Carolina, N.A. v. Variable Life Annuity Co., 513 U.S. 251(1995), 115 S. Ct. 810 (1995) (“VALIC”). Many activities that are not included in the enumerated powers are also part of the business of banking. Judicial

precedent reflects three general principles used to determine whether an activity is within the scope of the “business of banking”: (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; and (3) does the activity involve risks similar in nature to those already assumed by banks. See, e.g., Merchants’ Bank v. State Bank, 77 U.S. 604 (1871); M & M Leasing Corp. v. Seattle First Nat’l Bank, 563 F.2d 1377 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978); American Ins. Ass’n v. Clarke, 865 F.2d 278 (2d Cir. 1988).

## **B. UBK’s Net Lease Proposal is Within the Scope of the Business of Banking**

### **1. UBK’s Proposal is Functionally Equivalent to or a Logical Outgrowth of Secured Lending**

UBK’s residential real estate financing proposal is functionally equivalent to or a logical outgrowth of secured real estate lending or mortgage lending, activities that are part of the business of banking. See M & M Leasing Corp. v. Seattle First Nat’l Bank, 563 F.2d 1377 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978). National banks are expressly authorized to make loans under 12 U.S.C. § 24(Seventh) and underwrite mortgages under 12 U.S.C. § 371. But, in the current financial marketplace, lending takes many forms. Today, banks structure leases so that they are functionally equivalent to lending secured by personal property. In the M & M Leasing decision, the court noted that in appropriate circumstances, a lease transaction may constitute a loan of money secured by the property leased. Id. at 1380. The court reasoned that because secured lending and personal property leasing are functionally interchangeable, personal property leasing was within the business of banking and was therefore permissible. Id. at 1382. According to the court, a lease that has the economic attributes of a loan is simply a new way of conducting an activity that is within the business of banking.

Although the Ninth Circuit was careful not to define the “outer limit of the ‘business of banking,’” it rejected a narrow interpretation of national banks’ leasing authority. In the M&M Leasing decision, appellants argued that secured lending to permit the acquisition of property could be accomplished through traditional forms, and that a loan of money on personal security should be accomplished by a loan secured by a chattel mortgage or a conditional sales contract. Id. The Ninth Circuit rejected this narrow view of the “business of banking” and stressed that the “functional interchangeability” of leasing and lending was the touchstone of its decision. Id. at 1383. The Court’s point, stated differently, is that when the economic characteristics of a lease are substantially similar to a loan, the lease may be considered to be functionally equivalent to the loan. Therefore, the substance of the transaction, rather than its form, should guide our analysis.

The Ninth Circuit also emphasized that its holding was not without limits. The Court did not embrace the view that national banks may engage in any type of leasing activity. Id. at 1393. For example, a lease, which from its inception inevitably must be repeated or extended to enable the bank to recover its advances plus profit, is not a “loan of money on personal security.” Id. at 1384. A lease of this nature would be more akin to conducting a rental business. To engage in

this type of business would cause national banks to assume risks that they are not permitted to undertake. Id. In making this distinction, the court made it clear that only those leases which were functionally interchangeable with loans were within the “business of banking.”

The principles articulated in the M & M Leasing decision are not unique to personal property leasing. In reaching its conclusion that 12 U.S.C. § 24(Seventh) permits national banks to lease personal property, the Ninth Circuit stressed that personal property leasing did not define the “outer limit of the ‘business of banking,’” and that the powers of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking. Id. at 1382.<sup>1</sup> The court drew comfort in noting that “commentators unanimously have recognized that the National Bank Act did not freeze the practices of national banks in their nineteenth century form,” and cautioned that an overly “technical reasoning [of the statute] could stop the development of a new machinery rendered necessary by the new needs of an expanding trade.” Id. at 1382. The Court recognized that the “business of banking” is in a constant state of evolution and must be given a broad and flexible interpretation to allow national banks to use modern methods and meet modern needs.

The M&M Leasing decision could be read to mean that the classification of the property as real or personal property should not determine whether national banks can participate in certain forms of lending transactions. Instead, the economic substance of the transaction, rather than its form, should guide our analysis of whether national banks can engage in a particular activity. The OCC has followed this line of analysis in many of our other precedents. See OCC Interpretative Letter No. 717, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,032 (March 22, 1996) (national bank’s purchase of tax certificates deemed to be authorized under 12 U.S.C. § 371 because it is functionally equivalent to the making or purchasing of real estate-secured extensions of credit); OCC Interpretative Letter No. 687, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,002 (August 5, 1995) (using transparency analysis to conclude that national bank may participate in a limited partnership which invests in a pool of bank eligible securities); OCC Interpretative Letter No. 649, reprinted in [1994 Transfer

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<sup>1</sup>For example, UBK’s proposal is similar to the bank’s lease of “big ticket” items, *i.e.*, boats, airplanes, mobile homes, etc., that was discussed in the M&M Leasing decision. In those circumstances, the customer calls the bank directly and expresses an interest in leasing a particular item. This contact is essentially to inquire about the availability of credit. The bank performs no procurement function. The customer chooses the item that he or she wishes to lease and negotiates the terms of the lease agreement with the merchant. If the bank decides that the customer is an acceptable credit risk, it then purchases the property and leases it to the customer. Delivery by the seller is made directly to the customer-lessee who makes the lease payments to the bank. Id. at 1380-81. In UBK’s case, the Lessee locates the property and arranges the terms with the Seller. The Lessee will then contact UBK and, if UBK decides that the Lessee is an acceptable credit risk, UBK will provide funding for the remainder of the purchase price. UBK will lease the property to the Lessee for a specified lease term. These types of leases impose no more onerous economic burdens on banks than other types of leases or a mortgage. Id. at 1381.

Binder] Fed. Banking L. Rep. (CCH) ¶ 83,556 (May 12, 1994) (retirement CD deemed to be a permissible financial product whose primary attributes are grounded in the bank's express authority to receive deposits, enter into contracts, borrow and otherwise fund their operations); OCC Interpretative Letter No. 388, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612 (June 16, 1987) (OCC opined that the issuance of mortgage-backed pass-through certificates evidencing ownership interests in a national bank's conventional mortgage assets represents a negotiation of evidences of debt and the sale of real estate loans); OCC Investment Securities Letter No. 29, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85, 899 (August 3, 1988) (national bank's investment in separate trusts funded by one company and guaranteed by the same company should be treated as investment in the securities of "one obligor" when determining whether a bank has complied with the investment limits of 12 U.S.C. § 24(Seventh) and 12 C.F.R. Part 1).

Courts have supported the Comptroller's position. See American Ins. Ass'n v. Clarke, 656 F.Supp. 404 (D.D.C. 1987), aff'd, 865 F.2d 278 (D.C. Cir. 1988) ("AMBAC"); Securities Indus. Ass'n v. Clarke, 885 F.2d 1034 (2d Cir. 1989), cert. denied, 110 S.Ct. 1113 (1990) ("SIA"). In the AMBAC decision, the D.C. Circuit emphasized that bank powers analysis should focus on the substance of the transaction and not proceed from the narrow and artificially rigid view of both the business of banking and the statute that governs that business. See AMBAC, 656 F. Supp. at 404. The court endorsed the OCC's position that in determining whether an activity constitutes part of the business of banking, the Comptroller may "look beyond the label given to a certain activity to determine whether or not it is permissible." Id. The court then upheld the Comptroller's determination that a national bank's issuance of standby letters of credit in the form of municipal bond insurance was the "functional equivalent" of the issuance of a letter of credit, which is a permissible banking activity under Section 24(Seventh). In reaching its decision, the court recognized that although neither letters of credit nor municipal bond insurance are enumerated as permissible bank products under the National Bank Act, extending credit is a fundamental banking practice that can take a variety of forms, notwithstanding the label given to the activity. Id.

The Second Circuit Court of Appeals used a similar approach in the SIA decision. In that case, the Second Circuit reviewed whether the National Bank Act permitted a national bank to sell pass-through mortgage-backed certificates. The bank had originated the loans and subsequently placed them in a pool. The loans were then transferred to a trust. In exchange for the pool, the trustee transferred pass-through certificates to the bank. The certificates were later sold publicly. The court agreed with the OCC's decision that the sale of pass-through certificates was, in substance, the use of a new mechanism to perform the "old job of selling bank assets." See SIA, 885 F.2d at 1044. See also OCC Interpretative Letter No. 388, *supra*. The court also agreed that the sale of pass-through certificates was incidental to the business of banking because it was "convenient and useful" in connection with the bank's sale of mortgage loans. See SIA, 885 F.2d at 1044. In reaching its decision, the Court of Appeals rejected the district court's analysis which focused on the form of the transaction rather than its substance. Id.

In VALIC, the Supreme Court considered whether national banks may serve as agents in the sale of annuities. The Comptroller considered the sale of annuities as “incidental” to “the business of banking” under the National Bank Act, 12 U.S.C. § 24(Seventh), and concluded that annuities are not insurance within the meaning of 12 U.S.C. § 92, which prohibits insurance sales by banks in towns with more than 5,000 people. See VALIC, 513 U.S. at \_\_\_\_\_. The Court agreed with the Comptroller’s interpretation that annuities should be classified according to their functional characteristics, id. at \_\_\_\_, and concluded that annuities are financial investment instruments, and not insurance. Id. at \_\_\_\_\_. The Court recognized that annuities serve an important investment purpose and are functionally similar to other investments that banks typically sell. Id. at \_\_\_\_\_. Indeed, the Court equated annuities to having a savings account, a debt instrument, or mutual fund and stated that modern annuities, though more sophisticated than standard savings bank deposits of old, answer the same needs. Id. at \_\_\_\_\_. In effect, the Court rejected the label of insurance and looked at the substance of the instrument and determined that the bank may sell annuities as an incidental activity necessary to carry on the business of banking.

The principle of focusing on economic substance over form is also a recognized concept in Generally Accepted Accounting Principles and specifically applies to leases. A lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset by the lessee and as a financing by the lessor. In other words, in a lease that transfers substantially all of the benefits and risks of ownership to the lessee, the economic effect on the parties is similar to an installment purchase by the lessee. See Financial Accounting Standards No. 13 ¶ 60. A lease would generally be accounted for as a financing under Generally Accepted Accounting Principles if (1) the underlying property is transferred to lessee at the end of the lease or (2) the lease contains a bargain purchase that is reasonably assured of being exercised, and (3) it is reasonably certain that lease payments will be collected and (4) no uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease. See Financial Accounting Standards No. 13 ¶ 7.

Similarly, commercial law recognizes the principle of economic substance over form. For example, the Internal Revenue Service has adopted this concept and courts have affirmed IRS decisions that have relied upon this reasoning. See e.g., Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939) (courts are concerned with substance and formal written documents are not rigidly binding); Kirchman v. Comm’r, 862 F.2d 1486, 1491 (11th Cir. 1989) (courts should look to the substance of a transaction rather than just its form); Saller v. United States, 694 F.2d Supp. 224, 226 (E.D. Tex. 1988) (generally the substance of the commercial transaction, not merely its form, is determinative of questions of economic reality); Sun Oil Co. v. Comm’r, 562 F.2d 258, 263 (3d Cir. 1977) (court should look to the economic realities of a lease transaction and not to the labels applied by the parties); Carr Staley, Inc. v. United States, 496 U.S. 1366, 1375 (legal title to property is not the decisive factor in determining whether government may tax the income accruing to that property).

Specifically, the Internal Revenue Service developed objective factors to determine when a purported purchase and lease transaction may be recharacterized as a financing. See Rev. Rul.

55-540, 1955 IRB LEXIS 24. The Ruling states that in the absence of “compelling factors” to the contrary, the presence of one or more of the following factors warrants recharacterizing a purported lease as an installment sale or loan transaction:

- (a) Portions of the periodic payment are made specifically applicable to an equity interest that the lessee will acquire;
- (b) The lessee will acquire title upon payment of a stated amount of “rentals” which the lessee is required to make under the contract;
- (c) The lessee may acquire the property under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments that the lessee is required to make;
- (d) Some portion of the periodic payment is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

Id. See also Helvering v. Lazarus & Co., 308 U.S. 252 (affirming the Circuit Court and the IRS rulings).

This substance over form approach has been followed in the bankruptcy context. See In re Omne Partners II, 67 Bankr. 793, 795-797 (Bankr. D.C.N.H. 1986). There, the court stated that it may consider the parties’ intent and look through the form to the substance of the transaction to determine the rights of the parties. Id. at 795-797 (court found that the economic substance of a sale-leaseback transaction that included a “triple Net Lease” was not a disguised financing transaction).

Here, it is apparent that UBK’s Net Lease proposal is functionally equivalent to a financing transaction in which the Branch occupies the position of a secured lender. The transaction conveys the benefits and burdens of ownership to the Lessee. Once the Lessee enters into the sales contract, but before UBK funds the remainder of the purchase price, UBK and the Lessee negotiate the terms and conditions of the Agreements. Under the Net Lease, the Lessee will make periodic payments, maintain the property, pay charges, costs, and incur expenses attributable to the property that the owner would otherwise pay. UBK will ensure that the Lessee is capable of complying with the terms and conditions of the Net Lease. The Branch will review the creditworthiness of each Lessee to ensure that the Lessee can make minimum monthly lease payments. UBK will use the same formula that it uses to set traditional mortgage payments to determine the amount of monthly lease payments. The amount of the monthly lease payments will cover principal and interest and will be sufficient to amortize the entire purchase price by the end of the lease term. The Lessee will acquire title to the property at the end of the lease term or earlier if the Lessee pays the remainder of the purchase price. And, as is the case in a conventional mortgage transaction, the Lessee will not have to take any additional action to acquire title after the lease expires. Thus, UBK’s Net Lease proposal, in substance, has the characteristics of a financing transaction.



Our view that UBK's Net Lease proposal is functionally equivalent to financing is bolstered by UBK's representations that its proposal satisfies Generally Accepted Accounting Principles for lease financing transactions. The Internal Revenue Service also accepts the principle that a lease may be functionally equivalent to financing and UBK anticipates that the IRS will allow the Lessee to deduct the interest portion of the monthly lease payment from its taxes in the same manner as interest is deducted on a traditional mortgage. Moreover, the Net Lease proposal is not representative of the type of activity that the Ninth Circuit explained was outside of the "business of banking." The Net Lease proposal is not akin to conducting a real estate rental business because the Branch will not purchase or maintain an inventory of real estate to sell to customers. The Branch will not serve as a real estate broker or agent. Also, as will be explained more fully below, UBK's Net Lease proposal will not cause the Branch to assume impermissible risks. The Net Lease proposal is functionally interchangeable with secured real estate lending or mortgage lending, activities that are part of the business of banking, and represent a "new way" of providing financing. UBK's Net Lease proposal shows that the "business of banking" is not a static concept; instead, it is an evolving, organic concept that responds to developments in the financial marketplace and responds to the needs of the Branch's customers.

## **2. UBK's Net Lease Proposal Responds to Customers' Needs and Also Will Benefit UBK**

UBK's Net Lease proposal responds to the special issues regarding Islamic customers by providing an alternative method for a discrete group to get access to credit without forcing them to choose between their religion and home ownership. It allows followers of Islam to purchase homes without violating Islamic proscriptions on borrowing money on which interest is charged. Furthermore, UBK's Net Lease proposal is consistent with the well-established public policy of encouraging home ownership.

## **3. UBK's Net Lease Proposal Involves Risks Similar to Those Already Assumed by the Branch**

The risks posed by UBK's Net Lease proposal would be essentially the same as those associated with underwriting traditional mortgage loans. In both secured lending generally, and mortgage lending, in particular, the Branch makes a judgment concerning the borrower's creditworthiness. As with both arrangements, the Branch's decision to accept the credit risks are determined by the Branch's underwriting standards, which are derived from the Branch's lending experience and expertise. In a typical case, the Branch makes a loan to its customer secured by a lien on the property that is being purchased. The customer makes monthly mortgage payments until the loan is amortized. If the customer defaults on the loan, the Bank forecloses on the property, provides notice of sale, and sells the property. The bank also has the option of holding the property as OREO in accordance with 12 C.F.R. § 34. Here, UBK will follow the same procedures. UBK will not relet the property. Instead, UBK will characterize the property as OREO and dispose of it in accordance with 12 U.S.C. § 29 and 12 C.F.R. Part 34. Therefore,

UBK's risks under the Net Lease real estate finance program are similar to its risks on traditional mortgage loans.

UBK also proposes to pool and securitize its leases and ultimately sell them on the secondary market. UBK represents that there is an active market for securitized leases. This aspect of the Net Lease proposal is similar to the authority provided in 12 U.S.C. § 371(a) which allows national banks to sell loans. Twelve U.S.C. § 371(a) provides that:

Any national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interest in real estate, subject to section 1828(o) of this title and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.

12 U.S.C. § 371(a).

Even before the creation of this express authority for banks to sell their mortgage loans, however, the Supreme Court had already determined that the sale of mortgages and other evidences of debt acquired through a national bank's exercise of its express power to lend money on the security of real estate, and to discount and negotiate other evidences of debt, was authorized as part of the business of banking under 12 U.S.C. § 24(Seventh). See First Nat'l Bank of Hartford v. Hartford, 273 U.S. 548, 560 (1927). See also OCC Interpretative Letter No. 388, *supra*. Because national banks may sell their mortgage assets under the express authority of 12 U.S.C. § 24(Seventh) and 12 U.S.C. § 371(a), that rationale should extend to UBK's Net Lease proposal since the Branch's proposed activity is functionally equivalent to secured lending or mortgage lending. Moreover, a portfolio of prudently-arranged leases would not impose greater risks on the Branch than a portfolio of equally prudently-arranged loans. M&M Leasing, 563 F.2d at 1381-1382. UBK's Net Lease proposal provides the Branch with the ability to engage in more creative and flexible financing, and to become a stronger participant in the home finance market.

Furthermore, securitizing leases serves specific banking purposes. Securitizing leases which the Branch would otherwise hold for twenty or thirty years provides needed liquidity to the Branch's real estate finance program. This results in the generation of additional funds for new financing activities and other purposes. See OCC Interpretative Letter No. 388, *supra*. UBK anticipates that investors from the Islamic community, among others, will purchase these securities on the secondary market. Accordingly, the proposal responds to customers' needs and benefits UBK.

### **III. UBK's Proposal Does Not Violate the Policies of 12 U.S.C. § 29**

#### **A. Language and intent of 12 U.S.C. § 29**

The National Bank Act provides that national banks may “purchase, hold, and convey real estate for the following purposes, and for no other:

**First.** Such as shall be necessary for its accommodation in the transaction of its business.

**Second.** Such as shall be mortgaged to it in good faith by way of security for debts previously contracted.

**Third.** Such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings.

**Fourth.** Such as it shall purchase at sales under judgments, decrees, or mortgages held by the association, or shall purchase to secure debts due to it.

But no such association shall hold the possession of any real estate under mortgage, or the title and possession of any real estate purchased to secure any debts due to it, for a longer period than five years . . . .”

12 U.S.C. § 29.

At first glance it might appear that UBK’s Net Lease proposal is contrary to 12 U.S.C. § 29 because UBK will have legal title to the real estate.<sup>2</sup> But such a narrow view of the statute would elevate form over substance because, in this case, having legal title is largely cosmetic and the actual indicia of ownership are borne by the Lessee.

The Branch does not, and will not, actually hold real estate. It will not operate the property, pay taxes, insurance, and other charges, maintain upkeep of the premises, make repairs when necessary, assume liability for injuries or other accidents on the property, or otherwise exercise dominion and control over the property. The Lessee, and not the Branch, will bear these responsibilities. Although the Branch will have legal title to the property,<sup>3</sup> it will not take actual possession of the property at any point during the lease term. The Branch will only take possession of the property if the Lessee defaults or upon termination of the lease.<sup>4</sup> If the Branch does take possession of the property, it will take the property as OREO within the meaning of 12 U.S.C. § 29. Thus, despite the cosmetic appearance of the Branch holding real estate, the

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<sup>2</sup>Legal title refers to “one which is complete and perfect so far as regards the apparent right of ownership and possession, but which carries no beneficial interest in the property, another person being equitably entitled thereto.” Black’s Law Dictionary 897 (6th ed. 1990).

<sup>3</sup>The Branch may create or contract with a trust to hold title to the properties.

<sup>4</sup>It is unlikely that the Lessee will not take possession of the property at the end of the lease term because the Lessee will have made sufficient payments to acquire title to the property and no further steps will be necessary to take possession of the property. Therefore, the Branch is likely to take possession of the property only if the Lessee defaults on the lease.

substance of the transaction shows that the Branch and the Lessee will have an arms-length, mortgagor-mortgagee relationship.

While UBK's Net Lease proposal is unique, the concept is not. The OCC has supported this concept in at least three contexts in which national banks had legal title, but were not in violation of 12 U.S.C. § 29 because the substance of the transactions showed that the banks were not holding real estate. They buttress our view that analysis of 12 U.S.C. § 29 does not end with the form of the transaction.

The first context concerns providing financing to municipalities. See 12 C.F.R. § 7.1000(d). Twelve 12 C.F.R. § 7.1000 provides that:

A national bank may purchase . . . a municipal building, school building, or other similar public facility and, as holder of legal title, lease the facility to a municipality or other public authority having resources sufficient to make all rental payments as they become due. The lease agreement must provide that the lessee will become owner of the building or facility upon the expiration of the lease.

12 C.F.R. § 7.1000(d)(1). The regulation envisions that the parties will structure the lease so that it has the characteristics of a loan. See Letter from Robert J. Herrmann, Domestic Operations Division (June 15, 1977) (unpublished); Letter from Kenneth Leaf, CNBE (November 28, 1972) (unpublished); Letter from Thomas DeShazo, Deputy Comptroller of the Currency (October 23, 1968) (unpublished). The purpose of the regulation is to provide financing to municipalities secured by real estate.

The OCC has also declined to object to an analogous situation involving a land sale contract,<sup>5</sup> and has determined that such contracts are part of the business of banking. See OCC No Action Letter 86-2 from James M. Kane, District Counsel, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,008 (February 25, 1986) ("Kane Letter"). In the Kane Letter, a Lessee entered into a land contract with a Seller to purchase a home. The Lessee then paid a portion of the purchase price. The bank subsequently paid the remainder of the purchase price to the Seller who, in turn, assigned its interest in the land contract to the bank and conveyed a warranty deed<sup>6</sup> to the bank. The Lessee was legally prohibited from giving the bank a

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<sup>5</sup>A land contract (or land sale contract) is a contract for the purchase and sale of land upon execution of which title is transferred. The term commonly refers to an installment contract for the sale of land whereby Lessee receives the deed from the owner upon payment of the final installment. The vendor retains legal title to the property (deed) as security for payment of the contract price. Black's Law Dictionary 879 (6th ed. 1990).

<sup>6</sup>Warranty deed refers to a deed which explicitly contains covenants concerning the quality of title it conveys. The usual covenants of title are warranties of seisin, quiet enjoyment, right to

mortgage. The bank received title to the property incidental to its purchase of the land sale contract pursuant to 12 U.S.C. § 371 and 12 C.F.R. Part 34. The Lessee paid monthly installments to the bank. There, the OCC did not object to the transaction. Instead, we reasoned that the Seller's conveyance of title in the real estate to the bank while simultaneously assigning its interest in the land contract to the bank is incidental to the transaction because the transfer of Seller's interest in the real estate alone, if properly recorded, entitles the bank to a priority interest. Therefore, a land sale contract has the same substantive effect as a traditional mortgage if it is properly recorded.

UBK's proposal is analogous to the bank's purchase of an interest in the land sale contract discussed in the Kane Letter. UBK will fund the remainder of the purchase price and will have title to the real estate. It will simultaneously purchase and lease the property to the Lessee. The Lessee will make monthly payments to the Branch and UBK will transfer title to the Lessee at the end of the lease term. The Net Lease proposal is functionally equivalent to an extension of credit secured by a lien on, or an interest in, real estate, and is an alternative method that a Branch may use for financing real estate.

Furthermore, the OCC also did not object to a national bank holding a portfolio of Maryland ground rents. See Letter from William Glidden (January 17, 1996) (unpublished). A ground rent is a reversionary interest in an estate in land which is subject to a perpetually renewable lease. The only covenants are the payment of rent and taxes.<sup>7</sup> The OCC did not object to the interpretation of Maryland statutory and common law that the ground rent arrangement was more akin to a mortgagor-mortgagee relationship than a landlord-tenant relationship. We agreed with the reasoning that the Maryland ground rent was functionally equivalent to holding a security instrument to secure payment of money due under 12 U.S.C. § 371, rather than an investment in real estate within the meaning of 12 U.S.C. § 29. The Internal Revenue Service's interpretation allowing a lessee's payment of ground rent to be treated as a deduction in the same manner "as interest on indebtedness secured by a mortgage" bolstered our conclusion. See 26 U.S.C. § 163(c). Similarly, the Federal Housing Administration ("FHA") historically treated

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convey, freedom from encumbrances and defense of title as to all claims. Black's Law Dictionary 1589 (6th ed. 1990).

<sup>7</sup>The following example demonstrates how a ground rent is created. A buyer purchases a house which cost \$16,000. The bank holds the ground rent to the property which is valued at \$2,000. The ground rent lessee possesses the vast majority of the "bundle of rights" traditionally associated with ownership of property. The buyer is given absolute control over property subject only to the buyer's payment of taxes and lease payment. The buyer has an absolute right to "redeem," or acquire the fee estate in, the property at the time of the Buyer's choice, and for a sum certain. See Md. Code Ann. § 8-110 (1996 Repl. Vol.).

ground rents like mortgages.<sup>8</sup> Accordingly, we concluded that the Maryland ground rent arrangement did not violate 12 U.S.C. § 29.

In each of these circumstances, we looked beyond labels to the substance of the transaction and allowed national banks to find creative ways to finance real estate even if the bank, as a technical matter, had legal title. Such financing transactions are permissible if, as here, the obligor is creditworthy, the transaction is functionally akin to a traditional mortgagor-mortgagee arrangement, rather than a landlord-tenant relationship, and the transaction would not expose the bank to undue risks.

UBK's Net Lease proposal is also similar to "riskless principal" securities transactions in which a broker executes a purchase (or sale) only if it can conduct an offsetting sale (or purchase). See OCC Interpretative Letter No. 371, reprinted in [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85, 541 (June 13, 1986) (bank's subsidiary may act as broker of securities of foreign issuers where customer's order to purchase a security is offset by an order to sell the same security). A "riskless principal" transaction occurs when a broker, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security to offset a contemporaneous sale to (or purchase from) the customer. See Id. See also OCC Interpretative Letter No. 626 reprinted in [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 49, 101 (July 7, 1993) (bank permitted to act as broker for the sale of preferred equity and investment grade-rated debt securities on behalf of institutional investors in secondary market transactions). The OCC approved such transactions because the bank did not assume any of the customer's risk of loss, did not assume any liability as guarantor or endorser of the value of the securities, and did not have any beneficial ownership of the securities. In looking at the substance of the transactions, we recognized that riskless principal transactions were functionally equivalent to securities brokerage, and that the bank assumed the responsibilities and obligations ordinarily assumed by a securities broker, *i.e.*, risk of customer default at settlement. See Id. See also Bankers Trust New York Corporation, 75 Federal Reserve Bulletin 829 (October 30, 1989) (Federal Reserve Board Order which concluded that Bank would not be acting as a dealer for its own account in buying or selling securities in a riskless principal capacity because the Bank would not assume the risk of ownership of the securities); The Bank of New York Company, Inc., 82 Federal Reserve Bulletin 748, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 100, 043 (June 10, 1996) (Federal Reserve Board Order which concluded that riskless principal transactions do not constitute securities underwriting or dealing and are essentially equivalent to brokerage activities). We therefore concluded that the brokerage activity did not violate the prohibition on bank underwriting and dealing in securities contained in 12 U.S.C.

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<sup>8</sup>The policy of the FHA was to guarantee loans up to 80% to 90%, depending on the status of the property. In guaranteeing mortgages on leasehold estates, the FHA deducted the capitalized value of a redeemable ground rent from the value of the property. Thus the FHA did not consider the leasehold as a separate entity. Instead, it valued the property as a whole and deducted the capitalized value of the ground rent as if it were a mortgage.

§ 24(7) since the transactions were without recourse to the bank and were on the order of and for the account of the customer.

Here, UBK's will function like a "riskless principal" because it will not purchase any real estate until the Lessee requests that it do so, and the Lessee enters into a Net Lease to occupy the property immediately and a Purchase Agreement to take title to the property at the end of the lease term. Once UBK purchases the real estate from the Seller, it will transfer all indicia of ownership to the Lessee. The Lessee will be the beneficial owner of the real estate. UBK will assume no greater risks than it already assumes when it underwrites a traditional mortgage. UBK will not purchase real estate for its own portfolio. UBK will not hold itself out as a real estate broker or agent. UBK will not maintain an inventory of real estate for sale to customers. If a Lessee defaults on the Agreements, UBK will consider the property to be OREO and dispose of it in a manner consistent with 12 U.S.C. § 29 and 12 C.F.R. Part 34.

#### **B. UBK's Net Lease Proposal Is Not Inconsistent With Goals of Section 29.**

The restrictions in section 29 are intended to: (1) keep the capital of banks flowing into the daily channels of commerce; (2) deter banks from embarking on hazardous real estate speculations; and (3) prevent banks from accumulating and holding large masses of real estate in perpetuity. See *Union Nat'l Bank v. Matthews*, 98 U.S. 621, 626 (1878). See also OCC Interpretative Letter No. 770, reprinted in [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,134 (February 10, 1996); OCC Interpretative Letter No. 758, reprinted in [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,122 (April 5, 1996); OCC Interpretative Letter No. 717, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,032 (March 22, 1996); OCC Interpretative Letter No. 613, reprinted in [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,453 (January 15, 1993).

UBK's Net Lease proposal does not conflict with any of the purposes underlying the restrictions of section 29. First, UBK's Net Lease proposal would not impede the flow of capital to commerce. To the contrary, UBK's Net Lease proposal creates an alternative means of providing access to credit to an unserved segment of prospective home buyers. Without the program, these individuals effectively will not have access to credit. Second, UBK's Net Lease proposal is neither hazardous nor speculative because the program will be limited to single family residential homes selected by its customers for their own occupancy. The Branch will not purchase or maintain an inventory of properties to sell to customers. The Branch will not be exposed to greater risks than it would face in a traditional real estate financing transaction since the parties will structure the transaction to be the functional equivalent of a standard mortgage. Third, UBK will not hold legal title in perpetuity because it will transfer title at the end of the lease term or earlier if the Lessee pays the remainder of the purchase price. Also, similar to a traditional mortgage, if the Lessee defaults on the lease, UBK would consider the property to be OREO and dispose of it in accordance with 12 C.F.R. Part 34. Thus, UBK's Net Lease proposal satisfies the terms and intent of Section 29 while providing access to credit to a discrete group that has previously been unable to obtain financing to purchase homes.

#### **IV. Conclusion**

Based upon the forgoing discussion, and the commitments and representations made by UBK, we conclude that UBK's Net Lease proposal is permissible. If you have further questions concerning the foregoing, or need any additional information, please feel free to contact me or Denver Edwards, Attorney, at (212) 790-4010.

Sincerely yours,

/s/

Jonathan H. Rushdoony  
District Counsel