

*Testimony of*

Edward L. Yingling

*On Behalf of the*

AMERICAN **BANKERS** ASSOCIATION

*Before the*

Subcommittee on Government Management, Finance, and Accountability

*Of the*

Committee on Government Reform

United States House of Representatives

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Mr. Chairman and members of the Subcommittee, my name is Edward L. Yingling. I am President and Chief Executive Officer of the American Bankers Association (“ABA”). The ABA, on behalf of the more than two million men and women who work in our nation’s banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies, and savings banks – makes ABA the largest banking trade association in the country.

Thank you for the opportunity to present the ABA’s views on three recent letter rulings by the Office of the Comptroller of the Currency (“OCC”). In each of these rulings, the OCC did what a responsible regulator should do: It applied existing law to today’s facts. In so doing, the OCC has made it possible for national banks to continue serving as economic catalysts for communities across America and to meet the changing needs of bank customers within the existing legal framework.

In my testimony I would like to make the following three points:

- First, the OCC acted well within its authority when it approved banks to develop their premises and to engage in a transaction that is the functional equivalent of lending.

- Second, the challenge by the National Association of Realtors (“NAR”) to the OCC’s actions is misguided and has the potential to harm the vitality of downtowns across America and to impede investments that Congress has sought to encourage.
- Third, bank regulators need the flexibility to respond to a dynamic industry by permitting the industry to evolve within the limits established by Congress.

These points are discussed in further detail below.

### **1. The OCC acted well within its authority when it approved banks to develop their premises and to engage in a transaction that is the functional equivalent of lending.**

#### Bank premises

The OCC issued two letters last December approving requests by banks to develop their premises in economically viable ways that would address the banks’ operational needs. In considering these requests, the OCC applied precedents that have existed for over 100 years.

Congress included in one of the first codifications of statutes governing national banks the authority for a national bank to hold real estate for the conduct of its business. A national bank using this authority must act in good faith, acquiring the real estate for bank use and not for speculation. Having acquired the property in good faith, the bank is authorized by law to use excess space in the real estate in the same way that a prudent person would use such real estate.

This “prudent person” rule has been in place since 1904, the year in which the United States Supreme Court decided the seminal case of Brown v. Schleier. In that case the Court affirmed the opinion of the lower court, which stated –

Nor do we perceive any reason why a national bank, when it purchases or leases property for the erection of a banking house, should be compelled to use it exclusively for banking purposes. If the land which it purchases or leases for the accommodation of its business is very valuable, it should be accorded the same rights that belong to other landowners of improving it in a way that will yield the largest income, lessen its own rent, and render that part of its funds which are invested in realty most productive.

The court went on to state that “[T]he national bank act permits banking associations to act as any prudent person would act in making an investment in real estate, and to exercise the same measure of judgment and discretion.” The OCC’s recent approvals of bank petitions to develop bank premises is simply an application of this well-established authority to today’s marketplace.

This authority has enabled national banks to serve as the anchor of downtowns in cities and towns throughout America for over a century. Attached to this testimony are three examples – out of the thousands that exist – of banks that have used their premises to revitalize their downtowns. In some instances, a bank deliberately built a larger structure than it needed so that it would have room to grow. In others, a bank acquired the space that was available even though it was larger than the bank’s present needs required. In each case, the bank used the extra space productively to attract other businesses, and in the process strengthened the vitality of the downtown.

Frequently, banks will provide space to local charities and governments. Bank buildings also attract other businesses, such as accountants, doctors, lawyers, and even realtors to downtown. In the examples attached, one of the banks turned excess space into a gathering place for the community while another bank provides space to a non-profit Main Street organization. The common thread in all of these is that mixed-use bank buildings are catalysts for economic activity.

When banks construct or acquire their premises, the economics of the transaction often requires that a building be designed for mixed-use purposes. The OCC recognized this when, in one of the letters challenged by the NAR, the OCC permitted a bank to construct a building that would provide office space for the bank and others, as well as providing space for retail activity, hotel rooms, and condominiums. The proposed mix of space was deemed necessary to make the building financially viable. It also was viewed as important to the rejuvenation of the downtown in which the building is to be located.

The OCC has appropriately recognized that a bank has many uses for its premises. For community banks, the needs may center on local banking operations. For banks operating nationwide or

internationally, the needs may include accommodating bank clients and employees traveling on bank business.

The variations may differ but the theme remains the same: Banks need space to conduct their operations and, having acquired space, banks should be permitted to use that space productively. The OCC and courts have clearly and consistently affirmed that banks have ample authority to acquire bank premises and use them just as any other landowner would. The recent bank premises letters issued by the OCC simply apply this time-honored precedent to current facts.

It also is worth emphasizing that banks have been developing their premises for decades without any problems. That is because, despite allegations to the contrary, the authority is in fact very limited and subject to strict prudential limitations.

#### Functional equivalent of lending

The authority of banks to engage in transactions that are the functional equivalent of lending is equally well settled. Courts for decades have looked at the economic substance of a transaction rather than its form to determine whether a given activity is permissible for insured depository institutions. In the leading case in this area, M & M Leasing Corporation v. Seattle National Bank (1977), the court concluded that a national bank, pursuant to its authority to “make a loan of money on personal security,” may enter into leases that are “functionally interchangeable” with a secured loan.

Banks, as a general rule, are not permitted to own non-financial commercial firms, and the ABA strongly supports this separation of banking and non-financial commerce. However, for many years banks have been permitted to take technical ownership as part of a transaction that is carefully structured to be, in effect, an extension of credit. Leasing arrangements are one common set of such examples, although there are many others. When a consumer leases a car, the lender owns it but the lease is generally a substitute for a car loan. Simply put, these types of financings occur all the time.

The OCC frequently has looked through the form of a transaction to its substance and permitted a national bank to take an equity interest in connection with the financing of many types of projects,

including, most recently, a wind energy project. In order for that project to be economically viable, the bank providing the funding needed to take an equity interest in the company that would operate the project. This enabled the bank to use the tax credits to attract capital to the project, tax credits that would have been unavailable to a nonprofit entity.

The financing of the wind energy project in question was, at its core, the functional equivalent of a loan. The equity interest taken by the bank did not affect the underlying fundamentals of the transaction. The OCC supported this conclusion by listing in considerable detail the factors that led the agency to conclude that the project “would be substantially identical to a recognized form of extension of credit.” Among the factors considered was the fact that the day the tax credit runs out, the bank’s equity interest is required to end. This clearly demonstrates that this transaction is structured as a financing mechanism around the tax credit. Applying M & M Leasing, the OCC concluded that the bank was authorized to engage in the activity, within careful safeguards.

For years banks have taken equity interests in many other projects, including projects to fund historic rehabilitation, low-income housing, and community revitalization. The real owner of the projects frequently is a nonprofit corporation, which has no ability on its own to make use of a tax incentive. For the non-profit to make use of the tax credit, it usually needs to work with a commercial bank, which can use the tax credit to reduce the effective cost of financing to the non-profit entity. In many cases, though, for the bank to qualify for the tax credit, it must take an equity interest in the project. That is to say, to attract additional sources of funding, a loan often will be structured as an equity investment so that a bank may benefit from the tax incentive and the non-profit may receive the funding it needs, often at reduced overall costs.

The results speak for themselves. For example, in 2005, the low-income housing tax credit attracted \$7.5 billion in private equity capital. That same year saw over \$3 billion invested in community development projects by national banks alone, of which approximately 90 percent was invested in projects for which tax credits were received. The OCC estimates that next year \$7 billion will be received in New

Markets tax allocation credits by insured depository institutions. Without the ability to structure loans as equity investments, these results would not be achieved and the Congressional policy objectives would be frustrated.

The OCC's authorization of a national bank to finance a wind energy project is merely another example of the system working exactly as it should. The transaction reviewed by the OCC clearly is consistent with the law and policy established by Congress. In speaking about this approval as well as the two approvals for banks to develop their premises, Congressman Michael Oxley, Chairman of the House Committee on Financial Services, stated that "The actions that the OCC has taken in its authorization letters are reasonable, well within the law, and within precedent."

**2. The NAR's challenge to the OCC's actions is misguided. Moreover, it has the potential to harm the vitality of downtowns across America and to impede investments that Congress has sought to encourage.**

The NAR has publicly claimed that the three OCC approvals have put our banking system on a path that will lead to a reprise of the savings and loan crisis or another Japanese-style banking meltdown. This rhetoric is misguided.

National banks have only limited authority to invest in real estate or in commercial activities. The relevant statute states that a national bank may purchase, hold, and convey real estate only for the following purposes:

**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.

Even this limited authority for a bank to invest in real estate for bank premises is subject to a number of safeguards designed to ensure that the authority cannot be misused. First, as noted above, any

investment in bank premises must be made in good faith, *i.e.*, for the bank's use and not for the purpose of speculating in real estate. Second, banks may not make investments in bank premises that would exceed a specified percentage of bank capital. Third, a bank must obtain the prior approval of its primary federal regulator under certain circumstances.

Moreover, a national bank may not use a financial subsidiary to engage in real estate development activities that are prohibited for the bank. Congress was very clear in the Gramm-Leach-Bliley Act ("GLBA") that real estate development is *not* an activity that a financial subsidiary of a national bank may engage in. Section 121 of GLBA states that "the activities engaged in by the financial subsidiary as a principal do not include ... real estate development or real estate investment activities, unless otherwise expressly authorized by law."<sup>1</sup>

Thus, banks are not permitted to make a business in real estate development. In essence, a bank's authority is confined to holding real estate as bank premises and in connection with making mortgage loans. This hardly places the banking system on the road to ruin. Instead, this limited authority is all about enabling banks to provide the services to their communities that they were chartered to provide.

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<sup>1</sup> The full text of section 121 of GLBA states, in relevant part:

(a) **AUTHORIZATION TO CONDUCT IN SUBSIDIARIES CERTAIN ACTIVITIES THAT ARE FINANCIAL IN NATURE.—**

(1) **IN GENERAL.—**Subject to paragraph (2), a national bank may control a financial subsidiary, or hold an interest in a financial subsidiary.

(2) **CONDITIONS AND REQUIREMENTS.—**A national bank may control a financial subsidiary, or hold an interest in a financial subsidiary, only if—

(A) the financial subsidiary engages only in—

(i) activities that are financial in nature or incidental to a financial activity pursuant to subsection (b); and

(ii) activities that are permitted for national banks to engage in directly (subject to the same terms and conditions that govern the conduct of the activities by a national bank);

(B) the activities engaged in by the financial subsidiary as a principal do not include—

(i) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death (except to the extent permitted under section 302 or 303(c) of the Gramm-Leach-Bliley Act) or providing or issuing annuities the income of which is subject to tax treatment under section 72 of the Internal Revenue Code of 1986;

(ii) real estate development or real estate investment activities, unless otherwise expressly authorized by law; or

(iii) any activity permitted in subparagraph (H) or (I) of section 4(k)(4) of the Bank Holding Company Act of 1956, except activities described in section 4(k)(4)(H) that may be permitted in accordance with section 122 of the Gramm-Leach-Bliley Act;

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National banks' authority to make an equity investment as part of a transaction that is the functional equivalent of lending is comparably narrow. The National Bank Act prohibits national banks from making equity investments except in a few specified instances. An equity interest taken solely to facilitate a transaction that is the functional equivalent of lending does not cross that statutory line.

As previously noted, the OCC carefully reviewed the wind energy project at issue. It looked at, among other things, the underwriting criteria applied by the bank, the extent to which the bank intended to become involved in the management of the underlying business, and whether the bank could realize a speculative gain or loss. Following this review, the OCC concluded that the wind energy project posed no greater risk to the bank than would a transaction structured as a direct loan. More broadly, the precedent presents no greater risk to our economy than does lending in general.

The NAR is making arguments that threaten banks' ability to continue serving their communities and their customers. As discussed above, banks have provided enormous benefits to towns and cities across America. Downtowns will suffer if banks lack the ability to develop their premises with mixed-used buildings. Without banks' ability to offer innovative financing structures, the ability to achieve the goals that Congress has sought to achieve through tax incentives – in areas such as community development, low-income housing, and renewable energy – will be undermined.

America will be a poorer place if the longstanding bank community investment practices described above become casualties of the NAR's campaign. It is perhaps ironic, but certainly unfortunate, that the ominous phantoms of economic catastrophe conjured up by the NAR could cause real economic harm.

### **3. Bank regulators need the flexibility to respond to a dynamic industry by permitting the industry to evolve within the limits established by Congress.**

The United States has benefited from a remarkably healthy banking industry. The health of that industry is due in large part to a regulatory system that permits banks the freedom to innovate. Congress

establishes the policy that guides our banking industry. Congress also relies on the bank regulators to implement the policy directives in the myriad of situations that banks face every day.

Our banking industry is as dynamic as our economy. As the needs of bank customers evolve, so must the ability of banks to respond to those needs. This, in turn, requires a regulatory system that is sufficiently flexible to permit safe, sound, and innovative ways of meeting customer needs.

We urge Congress to permit the regulators to continue doing what they do best, namely, rigorously apply safety and soundness principles in an environment that permits banks to grow and serve their communities.

## **CONCLUSION**

The OCC, in issuing the three letters that are challenged by the NAR, acted responsibly and in a manner that is consistent with applicable statutes and court cases. Despite breathless rhetoric to the contrary, the letters are very limited in scope. Certainly, and in fact obviously, they will not cause the downfall of our banking system or erode the boundaries between banking and non-financial commerce. Rather, the letters will permit banks to continue serving as economic catalysts for their communities and as creative sources of capital for their customers.