

February 7, 2006

Interpretive Letter 1-2006

Request Section 362.106(4), RSMo. Activity – Non-majority controlled investment in a mortgage broker and mortgage banking subsidiary.

In a January 12, 2006, letter on behalf of your bank you requested a determination under Section 362.106(4) of the Revised Statutes of Missouri that a Missouri state-chartered bank be authorized to make or retain a non-majority controlled investment in a mortgage broker and mortgage banking company to the same extent as a national bank pursuant to 12 U.S.C. Section 24, seventh.

The bank currently owns a 65 percent interest in a company that acts as a residential mortgage broker and mortgage banker. The company is organized as a limited liability company under Chapter 347 of the Revised Statutes. When a bank holds a more than majority controlling interest in a company engaged in activities that the bank may engage in directly the company is considered an authorized bank operating subsidiary under Section 362.105.

The bank proposes to sell one half of its interest (32.5 percent) to a sister national bank. Under these circumstances the subsidiary company will no longer be majority controlled by the bank and will no longer be considered a bank operating subsidiary.

National banks have been authorized under federal law – and particularly regulation and interpretive letters issued by the Comptroller of the Currency to make or hold non-majority controlled equity investments under certain limitations and requirements.

Legal Analysis - General

The Missouri Division of Finance has not previously addressed whether a state bank may acquire or hold a non-majority controlled interest in a business enterprise intended to engage in an activity permissible for the bank. Under federal law national banks are permitted to hold non-majority controlled equity investments subject to express conditions and four well defined requirements that have been determined by the

Comptroller of the Currency in various interpretive letters and in 12 CFR Section 5.36. Our research shows that the Comptroller has in fact issued an interpretive letter bearing on your request. This is Interpretive Letter No. 853, dated February 16, 1999.

The standards have been consistently applied by the Comptroller as follows:

(1) The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking (or otherwise authorized for a bank).

(2) The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

(3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

(4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

The Comptroller typically imposes conditions in addition to requiring compliance with these standards.

Standards 1, 2 and 4 assure that a bank does not engage in a non-banking activity or make investments that are contrary to law and particularly 12 USC sec. 24. Standard 3 assures that the safety and of a bank is not compromised by exposure to risks that are not under its full management and control by limiting the bank's legal liability and actual loss exposure.

Legal Analysis – Bank Request

(1) The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking (or otherwise authorized for a bank).

Banks are expressly authorized to make real estate secured loans under Section 362.105.1(1). Originating mortgage loans for the secondary market is authorized under this section as a selling and discounting activity. Originating activity is also considered an activity incidental to banking powers under Section 362.106(1) as it is necessary and convenient to the business of banking.

Under Section 1.4 of the LLC operating agreement the express business purpose of the LLC is making and originating residential mortgage loans. There are no other express purposes and thus the first requirement is satisfied.

(2) The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

The bank and its national bank affiliate will together control 65 percent of the LLC. Under Section 11.4 of the LLC operating agreement - the agreement (including the purpose under Section 1.4) - cannot be amended except by a majority in interest. The majority in interest under Section 2.1 is any individual or aggregate interest of 50 percent or more. With a combined 65 percent interest the bank and national bank hold effective veto power over any change in purpose of the LLC.

The bank states that in as much as state and national bank powers are similarly limited that no change in the line of business of the LLC could occur (due to the effective veto power of the investing banks) that the bank is able to assure the LLC will not engage in unauthorized activities. Thus, under the terms of the operating agreement the bank is able to prevent the LLC from engaging in activities that are not part of or incidental to the business of banking.

(3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

A. Loss exposure from a legal standpoint.

A bank that will not have majority-owned control of the operations of a business entity in which it invests must not assume unlimited liability. Under Section 347.057 of the Revised Statutes of Missouri, as a legal matter, investors in a Missouri limited liability company do not incur individual liability with respect to the liabilities or obligations of the limited liability company solely by reason of being a member or manager of the LLC.

The agreement does not appear to compromise the limited liability provided to investors under the law – including members and managers under Section 346.057. Thus, the bank's loss exposure is limited from a legal standpoint to the amount of the bank's investment in the LLC.

B. Loss exposure from an accounting standpoint.

Because the bank's ownership share does not present a majority and controlling interest for accounting purposes the bank may report it as an unconsolidated entity under the equity method of accounting. Thus, the bank's exposure from an accounting perspective will be limited to the amount invested in or loaned to the LLC and the bank will not have an open-ended liability for the obligations of the LLC.

(4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to the bank's banking business.

Through its investment in the LLC the bank will obtain an interest in a business that can only engage in activities that the bank could engage in directly – in this case mortgage brokerage and mortgage banking. The bank will have involvement in the management and governance of the business under the structure provided in the operating agreement of the LLC. The LLC's mortgage origination and mortgage banking activities will benefit the bank in its banking activities by providing a business structure for additional lending and origination opportunities that are intended to profit the bank as a member and owner. Thus, the bank's investment in the LLC is convenient and useful to the bank in carrying out banking activities and is not a mere passive investment. The fourth standard is satisfied.

Other matters

The Division has considered whether the business arrangement presents conflicts that trigger the requirements applicable to bank affiliates under Sections 23A of the Federal Reserve Act and Regulation W. It appears that these provisions do not apply because the bank will hold a more than 25 percent interest in the LLC which will allow the LLC to be considered a subsidiary rather than an affiliate for purposes of Sections 23A.

However, even absent these strict affiliate limitations the board of directors and management of the bank must continue to exercise due care and diligence to identify and resolve conflicts that could be detrimental the bank's interest. The business arrangement presented is complex and any dealing between the bank and the LLC or any of the members should be fully disclosed to the board and evaluated to assure the bank's interest is fully represented and that any insider conflict is addressed appropriately.

Because the LLC is engaged in banking activities on behalf of the bank the LLC will be subject to the Division's supervision, regulation and examination. To assure that the Division's access to necessary information is not obstructed or impaired the Division will require the bank and the LLC to execute and provide an examination agreement authorizing the Commissioner of Finance full and complete access to all records of the LLC as if the LLC were a majority owned and controlled subsidiary of the bank.

The bank will keep and maintain a complete and current record of the proceedings and documents related to this business arrangement including corporate authorizations, operating agreement, leases, letters of intent, rights of first refusal and all other ancillary agreements that affect and implement the business arrangement.

Determination and Conditions

Based upon the information and representations you have provided, and for the reasons discussed above, it is our determination that the bank is legally permitted to acquire and hold a non-majority controlled interest in an LLC engaged in mortgage brokerage and mortgage banking in the manner described herein, subject to the following conditions:

1. The LLC will engage only in activities that are part of, or incidental to, the business of banking and there will be no change in the authorized activities of the LLC absent prior notice to the Division of Finance;
2. The bank will have veto power over any new proposed activities of the LLC that are inconsistent with condition number one;
3. The bank will account for its investment in the LLC under the equity method of accounting;
4. The LLC will be subject to the Division's supervision, regulation and examination;
5. The bank will keep complete records.

These conditions are imposed in writing in connection with the bank's request under Section 362.106 for a legal analysis and opinion confirming the bank's authority under Chapter 362, RSMo. The conditions are enforceable as conditions imposed in writing under Section 361.260, RSMo.

If bank examiners conclude based on subsequent developments that the investment is not safe and sound for the bank, the bank can be compelled under regulatory authority to take necessary action to operate in a safe and sound manner.

Because this matter also involves a non-majority controlled interest held by a national bank the Office of the Comptroller of the Currency may have regulatory concerns and impose conditions that affect the business and affairs of the LLC. Our office will coordinate our activities with other regulators to avoid any undue and unnecessary regulatory burden. However, we do not make any assumption or offer you any opinion concerning any conditions or limitations that the Comptroller may place on the proposed national bank participant in this matter.

Findings

Subject to the limitations and conditions presented in this letter the proposed activity - non-majority controlled investment in a mortgage brokerage and mortgage banking subsidiary - does not present an unsafe and unsound activity. Any bank considering such an investment should exercise normal diligence prior to making an investment and subsequently in monitoring and evaluating the investment.

This letter will be filed today with the Office of the Missouri Secretary of State and posted on the public internet website of the Division of Finance www.missouri-finance.org. This letter is effective ten days after filing with the Secretary of State. Any Missouri bank may conduct the activity authorized under this letter subject to the standards and limitations imposed. If you have any questions regarding this matter please contact Keith Thornburg, our chief counsel.

Very truly yours,

D. Eric McClure
Commissioner of Finance

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cc: FDIC

Comptroller of the Currency