



**Comptroller of the Currency
Administrator of National Banks**

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**Interpretive Letter #867
November 1999
12 USC 24(7)
12 USC 29**

June 1, 1999

Dear []:

This responds to your letter of February 8, 1999 to William P. Reinhardt, requesting our opinion on whether [] (“ ” or “Branch”), a Federal branch located in [*City*, *State*], may offer Murabaha financing products as part of the business of banking, pursuant to 12 U.S.C. § 24 (Seventh).

[] would like to offer these products to meet the special needs of its customers who adhere to the principles of Islam. The religious prescriptions of Islam or other faiths prohibit customers from borrowing money where the lender charges interest and, therefore, effectively prohibit such customers from engaging in loan transactions with the Branch. [] proposes an alternative arrangement, known as a Murabaha financing facility, to help Islamic customers engage in real estate financing transactions and commercial inventory and equipment financing transactions with the Branch.

Under the Murabaha financing facility, [] will essentially be functioning in a “riskless principal”/quasi-agency capacity, an activity which is not barred by section 29 of the National Bank Act and is permissible under section 24(Seventh). The Branch will acquire the property on behalf of the customer and then resell the property to the customer at a mark up on an installment basis. The Branch would like to use Murabaha financing facilities for the acquisition of real estate properties, real estate construction transactions, commercial inventory operations and the acquisition of commercial equipment to accommodate Islamic schools, mosques, community centers and businesses that traditionally have not had access to financing arrangements that are consistent with the religious beliefs of the participants in such community entities or the owners of such businesses. [] believes that the Murabaha financing transactions are permissible for a national bank and that the economic substance of the Murabaha financing transactions is functionally

equivalent to either a real estate mortgage transaction or an inventory or equipment loan agreement.¹

We agree with []'s conclusion. Based on the facts and representations [] presented, the Murabaha financing transactions are permissible for national banks as part of the business of banking under 12 U.S.C. § 24 (Seventh), and the economic substance of the Murabaha financing transactions is functionally equivalent to either a real estate mortgage transaction or an inventory or equipment loan agreement, as further discussed below.

[]'s Proposal

Commercial Transactions

In a Murabaha financing transaction, the customer will identify the property, inventory or equipment to be acquired, negotiate the purchase price with the seller, and apply to [] for financing. If the review of the proposal satisfies []'s ordinary credit underwriting criteria, [] will agree to simultaneously enter into a purchase agreement with the seller and a Murabaha agreement with the customer (the "Murabaha Agreement"). Pursuant to a purchase agreement, the Branch will purchase the property, inventory or equipment from the seller and then, pursuant to the Murabaha Agreement, immediately resell it to the customer at the original purchase price plus []'s cost and a profit amount which is the cost of financing the sale (the "Murabaha profit").²

In a Murabaha commercial inventory or equipment financing transaction, the customer and [] will enter into a master Murabaha agreement which will permit individual Murabaha transactions to be consummated pursuant to its terms (the "Master Murabaha Agreement").³ The aggregate total of individual transactions will not exceed the dollar limit specified in the Master Murabaha Agreement. Once a Master Murabaha

¹The OCC previously approved a net lease arrangement for []'s real estate transactions that was consistent with the religious prescriptions of Islam or other faiths. See OCC Interpretive Letter No. 806, *reprinted in* [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,253 (October 17, 1997). Under this net lease arrangement, [] acquired the property on behalf of the customer and leased the property back to the customer under a financing agreement over a period of time. Unfortunately, the net lease proved unworkable for certain not-for-profit customers of the Branch because the underlying real estate was subjected to various forms of taxation since it was held in the Branch's name and leased back to the not-for-profit organization. As a result, the Branch believes that a real estate Murabaha financing transaction would effectively eliminate this tax problem and allow the Branch to effectively serve its not-for-profit customer base.

² [] will add its margin to its costs of funds to calculate the Murabaha profit (the mark-up on the sale). In most cases, LIBOR will be used to determine []'s cost of funds. In all cases, the amount of the Murabaha profit will be calculated to comply with applicable usury laws.

³ The net lease structure previously discussed and approved by the OCC in Interpretive Letter No. 806, *supra*, does not work efficiently to finance inventory since the customer is constantly selling the property being financed and replacing it with new property. The lease structure has the significant disadvantage of involving [] in the sale of goods by the customer to a third-party customer, therefore, potentially exposing [] to potential liability to the third-party customer. Although this risk can be minimized through appropriate documentation, the Murabaha structure eliminates this risk completely.

Agreement for inventory financing is executed, the customer files with the Branch a purchase order with a promise to purchase requesting that [] buy specified goods from a seller. These goods might be raw materials, commodities or finished goods, or commercial equipment. This purchase order constitutes a firm commitment that the customer will purchase the goods from []. The resale price to the customer will include the cost of the goods, any shipping, handling, insurance or other costs with respect to the transporting of the goods, and the Murabaha profit which is typically based on a recognized index such as the London Interbank Offered Rate (“LIBOR”). [] will not enter into any sales agreement without having the firm commitment of the customer to purchase the goods from [].

Under the terms of the Master Murabaha Agreement, the customer will also execute an agency agreement in which the customer will act as agent for the Branch. The customer will select and inspect the goods to be purchased by the Branch, and under this agreement [] will have no liability to the customer for any failure on the part of the seller to either deliver the goods at the time specified in the sales contract or in conformity with the specifications of the sales contract. The customer also agrees to: (i) insure the goods or equipment and the Bank will be an insured party to the extent of its security interest, and (ii) to indemnify the Branch against all actions, claims and costs relating to the purchase of the equipment or goods by the Branch. Pursuant to an offer to purchase the goods, the customer will then certify that the goods or equipment conform to the qualitative and quantitative requirements of the sales contract. [] will not make any payment for the goods until the customer makes this certification. Pursuant to a notice of acceptance, [] will disclaim any warranties to the customer concerning the goods⁴ and []’s security interest in the goods or equipment will be set out in the Master Murabaha Agreement.⁵

The Branch will also require the customer to pay a downpayment of not less than twenty-five percent of the purchase price (excluding the Murabaha profit) to be paid by the customer for the goods before the Branch will agree to purchase the goods. The amount of the deposit will be determined in accordance with the Branch’s customary policies concerning the amount of down payments that are required for inventory financing transactions. In making its determination, the Branch will consider the creditworthiness of the customer and the nature of the goods being purchased.

[] represents that the underwriting standards used to evaluate Murabaha financing transactions will be identical to its current underwriting standards for conventional and net lease financings. [] also represents that the risks to the Branch in a Murabaha financing transaction are identical to the risks in a conventional mortgage or loan transaction. [] will not purchase the equipment or goods for its own

⁴ The Murabaha transactions ordinarily will not be done on an “open account” basis. Any proceeds from the sale of inventory will be used to pay the amount due for such inventory. Any new purchases of inventory will be subject to a separate Murabaha transaction. However, the Branch has represented that there may be occasions where, based upon the strong credit of the customer, [] would enter into an “open account” Murabaha financing. Any decisions concerning “open account” Murabaha financing would be based upon the same criteria that [] would use on conventional financings.

⁵ In most cases when the goods or equipment are sold to the customer by the Branch, the customer’s obligation to pay the purchase price will be secured by a security interest in the goods of the amount owed. The Branch will apply its customer underwriting standards in determining whether to provide financing on a secured or unsecured basis.

portfolio, will not maintain an inventory of goods or equipment for sale to customers, and will not hold itself out as a broker or agent.

[] will not operate the equipment, pay taxes, insurance or other charges on the goods or equipment, provide for upkeep or make repairs to the equipment when necessary, assume liability for injuries or accidents in the use of the equipment, or otherwise exercise dominion or control over the goods or equipment. If a commercial customer fails to purchase the goods or equipment under the Master Murabaha Agreement after the goods are purchased by [], the Branch will sell them for as much as it can obtain. [] will then seek to recover the difference between the amount realized on the sale of the equipment or goods and the amount the customer agreed to pay under a breach of contract action in the appropriate forum. The risk to [] is that the customer will have insufficient resources to meet its obligations. This is the same risk that [] would have under a conventional inventory or equipment financing had [] been forced to foreclose on the goods or equipment.

[] also represents that the Murabaha products will be financing products and they will be considered loans for both tax and accounting purposes.

Real Estate Transactions

In the case of a Murabaha real estate financing transaction, the customer will identify the real property, negotiate the purchase price with the seller, and apply to [] for financing. If the review of the proposal satisfies []'s ordinary credit underwriting criteria, [] will agree to simultaneously enter into a purchase agreement with the seller and a Murabaha Agreement with the customer. Pursuant to a purchase agreement, the Branch will purchase the real property from the seller and then, pursuant to the Murabaha Agreement, immediately resell it to the customer at the original purchase price plus the Murabaha profit. In all cases, the customer will pay not less than a twenty-five percent downpayment of the purchase price (excluding the Murabaha profit) immediately and the balance over time. [] will not close on the purchase of the real estate unless the customer has deposited the downpayment amount with [] or its designee. Pursuant to a deferred sales contract, the customer will confirm that the Branch makes no warranties or representations to the customer and both parties agree that no other warranties are available. The balance due under the Murabaha Agreement will be secured by a first mortgage (or deed of trust) in favor of []. This mortgage also will require that the property be fully insured jointly in the name of the Branch and the borrower until all sums due under the Murabaha contract are repaid in full.

If the transaction involves construction, either new construction, expansion or renovation, then the customer will enter into a Master Murabaha Agreement in which the aggregate total of individual Murabaha transactions will not exceed the dollar limit specified. Each payment for building materials will be done pursuant to the Master Murabaha Agreement with the Branch purchasing the materials on behalf of the customer and immediately reselling them at the original price plus costs and the Murabaha profit. The deferred purchase price will be secured by a first mortgage (or deed of trust) on the property that will require insurance coverage as well. The aggregate amount that will advance in connection with any such project will be consistent with []'s normal underwriting criteria and will not exceed the amount that [

] would advance in a conventional construction financing.⁶

[] represents that the underwriting standards used to evaluate Murabaha financing transactions will be identical to its current underwriting standards for conventional and net lease financings. [] also represents that the risks to the Branch in a Murabaha financing transaction are identical to the risks in a conventional mortgage or loan transaction. [] will not purchase real estate for its own portfolio, will not maintain an inventory of real estate or goods for sale to customers, and will not hold itself out as a real estate broker or agent. Moreover, [] will not operate the property, pay taxes, insurance, or 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 or control over the property.

The purchase of the real estate by [] and the Murabaha financing transaction with the customer will occur simultaneously at a specified closing location where the required documentation will be finalized and signed. Before proceeding with the closing transactions, [] will first obtain the downpayment amount from the customer. At the closing transaction, title to the property will immediately pass from [] to the customer, the customer will agree to make payments to the Branch over a specified time period, and [] will obtain a security interest (mortgage) for the balance due under the Murabaha Agreement. [] will never take possession of the real estate being purchased and there will be no additional or unusual risks assumed by [] from holding the real estate for this brief period of time. If the customer ultimately defaults on the payment schedule in the Murabaha Agreement, [] would have the right to foreclose on the real estate under its mortgage as it would under any other conventional real estate transaction. The Branch would be able to sell the real estate for as much as it could obtain and then seek to recover the difference between the amount of the downpayment plus the amount realized on the sale of the real estate and the amount the customer agreed to pay under a breach of contract action in the appropriate forum. The Bank also has the option of holding the real property as OREO in accordance with 12 C.F.R. Part 34. Thus, the risk to [] is that the customer will have insufficient resources to meet its obligations under the Murabaha financing transaction. This is the same risk that [] would have under a conventional real estate financing had [] been forced to foreclose on the property.

⁶[] will protect itself from performance risk in exactly the same manner as financial institutions do in conventional construction financing. For example, prior to each disbursement of funds, [] will require a contractor's report as to construction progress, an architect's certification as to the accuracy of the contractor's report and lien waivers from subcontractors. The transaction will also be structured so that a portion of the amount [] will be providing to the builder will be retained until construction is substantially complete. All of these protections are standard in construction lending.

Legal Discussion

The Activities are Permissible for a National Bank

A national bank may engage in activities that are part of, or incidental to, the business of banking under 12 U.S.C. § 24 (Seventh) (a national bank may carry on the business of banking “. . . by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits . . . [and] by loaning money on personal security. . .”). Moreover, national banks have the express authority under § 24 (Seventh) to make loans and underwrite mortgages under 12 U.S.C. § 371. A loan or extension of credit is defined 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 a specific property pledged by or on behalf of the borrower.” 12 C.F.R. § 32.2(j)(1998). The Murabaha financing transactions proposed by the Branch fit this definition and are therefore permissible banking activities.

In the current financial marketplace lending takes many forms. []’s Murabaha financing proposals are functionally equivalent to or a logical outgrowth of secured real estate lending and inventory and equipment financing, activities that are part of the business of banking. The economic substance of the transaction, rather than its form, guides our analysis of whether national banks can engage in a particular activity. The OCC has followed this line of analysis in many other precedents. *See* OCC Interpretive Letter No. 806, *reprinted in* [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,253 (October 17, 1997) ([]’s net lease transactions functionally equivalent to conventional mortgage financings); OCC Interpretive 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 functionally equivalent to the making or purchasing of real estate-secured extensions of credit); OCC Interpretive 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). The courts have regularly supported the OCC’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) (bank powers analysis should focus on the substance of the transaction); *Securities Indus. Ass’n v. Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 110 S.Ct. 1113 (1990) (the sale of pass-through certificates is, in substance, the use of a new mechanism to perform the “old job of selling bank assets”).

Here, it is apparent that []’s Murabaha financing proposals are functionally equivalent to conventional financing transactions. [] will advance the money to purchase the property or inventory under an obligation from the customer to repay the amount advanced plus the Murabaha profit on an amortized basis upon resale of the property by the Branch to the customer. The obligations will be secured by a mortgage (or security interest) on the facility, equipment or goods, and the amount due will be repaid to the Branch on an amortized basis. []’s ownership of the real estate or equipment/inventory will be for a moment in time, and it will not purchase or maintain an inventory of properties or goods/equipment to sell to customers. Also, from an accounting and a tax perspective, the Murabaha financing transactions will be considered loans on []’s books and they will be treated exactly the same as conventional real estate or inventory/equipment financings. The Branch will not be exposed to greater risks than it would face in

a conventional real estate or commercial financing transaction. Thus, the Murabaha transactions are functionally equivalent to conventional real estate or inventory financings where the purchasers would borrow money from the bank to acquire the facility, equipment or goods, secure the loan with a mortgage (or security interest), and repay the loan on an amortized basis to the bank.⁷

The Real Estate Murabaha Financing Transaction is not Contrary to the Restrictions on Bank Ownership of Real Property

Section 29 of the National Bank Act provides that a national bank may purchase, hold, and convey real estate for the following purposes, and for no others:

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 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 ... or shall purchase to secure debts due to it.

The restrictions of 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, e.g., Union Nat. Bank v. Matthews*, 98 U.S. 621 (1878); Interpretive Letter No. 806, *supra*, p.15.

With regard to the real estate Murabaha financing and the restrictions on bank ownership of real property set out in 12 U.S.C. § 29, it is established OCC precedent that a national bank may hold legal title to property, as a technical matter, when doing so is an integral part of a secured financing arrangement with its customer. *See* Application by National Bank of Commerce, Memphis, Tennessee, OCC Corporate Decision dated March 26, 1999 (unpublished) (a national bank, as part of a financing transaction, may acquire temporarily an interest in real estate); OCC Interpretive Letter No. 806, *supra*; No-Objection

⁷ As mentioned, []'s Murabaha financing transactions are 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). It is established OCC precedent that a national bank may engage in riskless principal transactions because they are functionally equivalent to securities brokerage and the bank assumes the responsibilities and obligations ordinarily assumed by a securities broker. *See* OCC Interpretive 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); *see also* OCC Interpretive 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). Here, [] will function like a "riskless principal" because it will not purchase the real estate, equipment or goods until the customer requests that it do so, and the customer agrees to immediately purchase the property from the Branch at the original purchase price plus []'s cost and Murabaha profit. [] will assume no greater risks than it already assumes in a conventional mortgage or loan transaction.

Letter No. 86-2 (February 25, 1986), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. ¶ 84,008 (permitting national bank to hold legal title to real property incidental to making a loan); Letter from Robert J. Herrmann, Deputy Comptroller (October 4, 1994) (unpublished) (trust's purchase of the production payments was permissible under section 29 as a preliminary step to further a secured financing transaction).

Each of these letters confirms that the key element in the 12 U.S.C. § 29 determination is that the property interest is being acquired in furtherance of a permissible banking activity. The Murabaha constitutes a bank's "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 a specific property pledged by or on behalf of the borrower." 12 C.F.R. § 32.2(j)(1998). The substance of the transaction remains that the Branch is providing financing to a customer for the acquisition of real property. Thus, the property interest is being acquired in furtherance of a permissible banking activity and it is proper to treat the transaction as an extension of credit that is permissible for a national bank.

Furthermore, the Murabaha financing transaction does not conflict with any of the purposes underlying the restrictions of section 29, *Union Nat. Bank, supra*; Interpretive Letter No. 806, *supra*. The Branch will not actually hold real estate. It will not operate the property, pay taxes, insurance, or 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 or control over the property. Although the Branch will have legal title⁸ for a moment in time, it will not take actual possession of the property at any point during the term of the financing. And similar to a conventional mortgage, if the customer defaults on the Murabaha financing, [] will consider the property to be OREO and dispose of it in accordance with 12 C.F.R. Part 34. Despite the appearance of the Branch briefly holding real estate, the substance of the transaction shows that the Branch and the customer will have an arms-length, mortgagor-mortgagee relationship. Thus, the real estate Murabaha financing transaction is not contrary to the restrictions on bank ownership of real property.

Conclusion

Based upon the foregoing discussion, and the commitments and representations made by [], we conclude that []'s Murabaha financing products are permissible. If you have further questions

⁸ 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)

concerning the foregoing, or need any additional information, please feel free to contact Senior Attorney James Vivenzio or me at (212) 790-4010.

Sincerely yours,

/s/

Jonathan H. Rushdoony
District Counsel