



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

March 21, 2005

Interpretive Letter #1024
April 2005
12 USC 375b
12 CFR 215.4

Subject: Application of 12 U.S.C. Section 375b(2)(A) and 12 C.F.R. Section 215.4(a)(1) to
Renewals of Loans to Bank Insiders

Dear []:

This letter responds to your inquiry regarding an interpretive issue arising under Regulation O. Specifically, the question is whether a bank that renews an extension of credit to its insider violates section 22(h)(2)(A) of the Federal Reserve Act¹ and the corresponding provision of its implementing regulation, section 215.5(a)(1) of Regulation O,² if the renewal, though not made on preferential terms, “involves more than the normal risk of repayment or presents other unfavorable features.”³ Consistent with the written position of the Board of Governors of the Federal Reserve System (“FRB”), we conclude that it does.

Regulation O imposes quantitative and qualitative restrictions on a bank’s loans and extensions of credit to its “insiders,” which include the bank’s principal shareholders, directors and executive officers, as well as companies controlled by such persons. The regulation defines an extension of credit to include “a renewal of any loan.”⁴ Among the regulation’s qualitative restrictions, section 215.4(a)(1) of Regulation O sets forth requirements regarding “Terms and Creditworthiness,” prohibiting the making of a loan or extension of credit to an insider unless the loan:

(i) Is made on substantially the same terms (including interest rates and collateral) as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions by the bank with other persons that are not covered by this part and who are not employed by the bank; *and*

¹ 12 U.S.C. § 375b(2)(A).

² 12 C.F.R. § 215.4(a)(1).

³ 12 C.F.R. § 215.4(a)(1)(ii).

⁴ 12 C.F.R. § 215.3(a).

(ii) Does not involve more than the normal risk of repayment or present other unfavorable features.⁵

Thus, on its face, Regulation O requires that any loan to a bank insider must satisfy *both* tests set forth above: The loan must be non-preferential *and* it must not present a greater-than-normal risk of repayment or other unfavorable features. Unless both tests are met, a bank's loan to its insider violates Regulation O. We believe that this interpretation is dictated by the plain language of the regulation and by the purposes of the underlying statute. Federal Reserve Board precedent supports this interpretation. In a 1994 opinion, the General Counsel of the FRB made clear that the renewal of an insider loan that involves more than the normal risk of repayment or presents other unfavorable features violates Regulation O.⁶

We are aware, however, of two old OCC staff opinions that take the position that "once an insider has been identified as posing a credit weakness, [a loan] may be renewed only if a comparable troubled loan to a non-insider would be renewed."⁷ These OCC letters thus appear to conflate the two tests in section 215.4(a)(1) by taking the position that a bank does not violate Regulation O by renewing a loan to an insider that involves more than the normal risk of repayment unless the loan renewal is also preferential. One of these letters premises this conclusion on the rationale that the purpose of Regulation O is to "prevent preferential treatment to insiders without imposing stricter standards on insider credit than on credit to other borrowers."⁸ However, as noted above, Regulation O clearly provides that a violation occurs if *either* test is not met. Concluding otherwise would render superfluous the section 215.4(a)(1)(ii)

⁵ 12 C.F.R. § 215.4(a)(1)(i) and (ii); *see also* 12 U.S.C. § 375b(2)(A) (emphasis added).

⁶ *See* Op. G.C. FRB (Oct. 21, 1994), 1994 Fed. Res. Interp. Ltr. LEXIS 322. Although the letter did not address Regulation O's preferentiality prohibition, by concluding that a loan may violate Regulation O if it violates § 215.4(a)(1)(ii), the letter implicitly supports the proposition that the loan need not also be preferential in order to give rise to a violation of Regulation O. *See also* Federal Reserve Bank of Dallas Staff Opinion (Ltr. from Millard E. Sweatt, Jr., Vice President and General Counsel, May 24, 1984) ("The general proscriptions of Regulation O, as set forth in Section 215.4(a), not only require that extensions of credit to insiders be made on substantially the same terms as those prevailing for comparable transactions with non-insiders, but also prohibit any extension of credit to insiders that involves more than the normal risk of repayment or that presents other unfavorable features.")

⁷ *See, e.g.*, OCC Interp. Ltr. No. 443 (June 28, 1988) ("The OCC's position is that once an insider loan has been identified as posing a credit weakness, it may be renewed only if a comparable loan to a non-insider would be renewed."). *See also* OCC Unpublished Interp. Ltr. (Oct. 31, 1990) (same conclusion). Another OCC letter opines in part that a bank can renew a loan to an insider that presents more than the normal risk of repayment if the purpose of the loan renewal is to improve the loan's credit quality. *See* OCC Unpublished Interp. Ltr. (Jun. 18, 1990). Although this letter did not cite to a specific provision of Regulation O for this proposition, the writer may have had in mind § 215.3(b)(4)(ii), which excludes from the definition of extension of credit "any indebtedness to a bank for the purpose of protecting the bank against loss or of giving financial assistance to it." But the FRB has opined that this provision "is intended to enable an insider to protect a bank against loss arising from a credit extended to an unrelated third party," and that it would not permit a bank "to renew a loan to an insider, assuming the renewal would [otherwise] violate Regulation O, where the insider is already obligated to repay the bank." Op G.C. FRB (Jun. 14, 1989).

⁸ OCC Unpublished Interp. Ltr. (Oct. 31, 1990).

requirement that a loan present no greater than normal repayment risk or present other unfavorable features.

Moreover, preventing preferential treatment is not the only purpose of Regulation O. Rather, its purpose has been more broadly described as “prevent[ing insiders] of a bank from exerting undue influence over the bank’s lending activities”⁹ and “limiting borrowing by executive officers and other insiders.”¹⁰ If the sole purpose of Regulation O were to prevent preferential treatment of insiders, there would be no need for the regulation’s imposition of quantitative limits or prohibition on certain overdrafts. The OCC letters referenced above predate the FRB’s 1994 opinion, and we believe that the better view is to read section 215.4(a)(1)(i) and (ii) as independent tests.

Accordingly, based on a plain reading of Regulation O as confirmed by the Federal Reserve Board opinion referenced above, we conclude that a national bank that renews a loan to an insider violates section 215.4(a)(1) of Regulation O and section 22(h)(2)(A) of the Federal Reserve Act if the loan either (i) is preferential or (ii) involves more than the normal risk of repayment or presents other unfavorable features. To the extent that earlier OCC staff opinions have suggested otherwise,¹¹ they are hereby overruled. I trust this reply is responsive to your inquiry. If you have any questions regarding the foregoing, please contact Aline J. Henderson at (202) 874-5300.

Sincerely,

-signed-

Daniel P. Stipano
Acting Chief Counsel

⁹ Op. G.C. FRB (Apr. 5, 1989).

¹⁰ Op. G.C. FRB (Feb. 28, 1995).

¹¹ See, e.g., OCC Interp. Ltr. No. 443 (June 28, 1988); OCC Unpublished Interp. Ltr. (Oct. 31, 1990) and; OCC Unpublished Interp. Ltr. (Jun. 18, 1990).