



COMMONWEALTH OF PENNSYLVANIA  
DEPARTMENT OF BANKING  
333 MARKET STREET, 16TH FLOOR  
HARRISBURG, PENNSYLVANIA 17101-2290

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April 28, 1998

Re: Notice of Change in Condition of Membership for

Dear Gentlemen:

This letter responds to the request you filed with the Pennsylvania Department of Banking (the "Department") on behalf of Bank (the "Bank"), a Pennsylvania state-chartered commercial bank.

As a matter of background, the Bank filed a Notice of Change in Condition of Membership for the Bank ("Notice") with the Federal Reserve Bank of Philadelphia ("Federal Reserve"). The Notice has been amended and substantially revised several times since the initial filing in August, 1997.<sup>1</sup>

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<sup>1</sup> Since the inception of this matter, numerous documents have been submitted to the Department on behalf of the Bank with respect to this request. On August 6, 1997, the Bank's counsel submitted an application for approval of an investment by the Bank in and On August 11, 1997, the Federal Reserve forwarded a draft Application for Change in Condition of Membership for the Bank, dated July 31, 1997, to the Department. On August 14, 1997, the Federal Reserve requested additional information regarding the July 31, 1997, draft Application. On February 3, 1998, the Bank's counsel submitted a revised Application for Change in Condition of Membership to the Department. On February 13, 1998, the Federal Reserve requested additional information regarding the revised Application for Change in Condition of Membership. On March 13, 1998, the Bank's counsel forwarded supplemental information to the Bank's Notice of Change in Condition of Membership to the Department. On March 20, 1998, the Bank's counsel sent a letter to the Department providing clarification of the Bank's proposed investment. On April 8, 1998, the Bank's counsel submitted another revised Notice of Change in Condition of Membership, which was amended and revised pursuant to two memoranda dated April 16, 1998.

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However, based upon the latest documentation and representations made to the Department, the Bank intends to purchase 49% of the common stock of \_\_\_\_\_ (“Acquisition Company”) which will own 100% of \_\_\_\_\_ (the “Mortgage Company Subsidiary”), a licensee under the Mortgage Bankers and Brokers Act (“MBBA”), 63 P.S. § 456.01 *et seq.*, and the Secondary Mortgage Loan Act (“SMLA”), 7 P.S. § 6601 *et seq.* The proposed ownership structure of the Acquisition Company is as follows:

- 1) Twenty percent (20%) will be owned by the existing individual shareholders of the Mortgage Company Subsidiary, which are listed under tab six to the supplemental information provided to the Department and the Federal Reserve under cover letter dated March 13, 1998.
- 2) Eighty percent (80%) will be owned by the owners of \_\_\_\_\_ Subsidiary (\_\_\_\_\_), a licensee under the MBBA and the SMLA, and the Bank.

\_\_\_\_\_ intends to pay for the common stock of the Acquisition Company by contributing or merging certain of \_\_\_\_\_ assets to the Acquisition Company at the time of the closing of the transaction. According to \_\_\_\_\_ letter dated April 8, 1998, and memorandum dated April 16, 1998, to the Department, the Bank intends to purchase 49% of the outstanding shares of the Acquisition Company which will own 100% of the Mortgage Company Subsidiary. \_\_\_\_\_ shareholders will own the common stock of the Acquisition Company individually and the Bank will own the common stock of the Acquisition Company directly.

The Bank represented in the Notice that the Bank does not anticipate that a lending or deposit relationship will exist between the Bank and the Mortgage Company Subsidiary. Further, it is the understanding of the Department that the Bank does not anticipate that a lending or deposit relationship will exist between the Bank and the Acquisition Company.

### Legal Analysis

Pennsylvania state-chartered commercial banks, such as Bank, are authorized to acquire and hold, without limitation of amount, the stock of subsidiary corporations engaged in activities permissible for such institutions and activities permissible under the Bank Service Corporation Act, 12 U.S.C. § 1861 *et seq.*, if the shares are acquired with the prior written approval of the Department. 7 P.S. § 203(d). In addition, a Pennsylvania state-chartered commercial bank, such as Bank, may, as an investment, acquire and hold shares of stock of a subsidiary corporation engaged in the functions or activities that an institution is authorized to carry on, if the shares are acquired with the prior written approval of the department. 7 P.S. § 311(d)(ii)(B.1). For purposes of sections 203 and 311 of the Banking Code of 1965 (“Banking Code”), 7 P.S. § 101 *et seq.*, a “subsidiary” is defined as “a corporation controlled by an institution which owns at least a majority of its shares.” 7 P.S. §

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102(bb.1).<sup>2</sup>

In the proposed transaction, the Bank proposes to own 49% of the common stock of the Acquisition Company, which will own 100% of the Mortgage Company Subsidiary. The remaining shares of the Acquisition Company will be owned by individuals as indicated above. Accordingly, the Acquisition Company will not be controlled by an institution which owns at least a majority of its shares. Therefore, the question presented is whether the bank could lawfully acquire and hold a minority interest in an acquisition company which owns 100% of a mortgage banking company. As you stated during a telephone conversation with Department counsel, the Mortgage Company Subsidiary is the Acquisition Company's only holding at this time.

The Office of the Comptroller of the Currency ("OCC") has determined that a national bank is permitted to own a minority interest in a mortgage banking company pursuant to a national bank's incidental powers under 12 U.S.C. § 24(Seventh), subject to certain terms and conditions. Upon review of the Bank's request, it is the conclusion of the Department that a Pennsylvania state-chartered commercial bank may own a minority interest in an acquisition company which owns 100% of a mortgage banking company as an incidental power, subject, at least, to the same terms and conditions imposed upon national banks by the OCC. *See* OCC Interpretive Letter No. 711 (February 23, 1996) Section 315(i) of the Banking Code provides that an institution shall have, subject to the limitations and restrictions contained in this act:

**(i) Incidental powers** - all powers incidental to the conduct of banking business.

7 P.S. § 315(i).

Accordingly, the Department's approval of the Bank's proposed minority investment in the Acquisition Company, which owns 100% of the Mortgage Company Subsidiary, is conditional upon and subject to the following terms and conditions:

- 1) the activities of the Acquisition Company and the Mortgage Company Subsidiary must be limited to activities that are part of, or incidental to, the business of banking;
- 2) the Bank must be able to prevent the Acquisition Company and the Mortgage Company Subsidiary from engaging in activities that do not meet the foregoing standard or be able to withdraw its investment;

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<sup>2</sup> An "institution" is defined as a bank, bank and trust company, a trust company, a savings bank or a private bank. 7 P.S. § 102(r).

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- 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 Acquisition Company or the Mortgage Company Subsidiary; and
- 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 business.

Each of the four conditions are discussed in greater detail below.

*Condition 1: The activities of the Acquisition Company and the Mortgage Company Subsidiary must be limited to activities that are part of, or incidental to, the business of banking.*

As stated in the Application, the Mortgage Company Subsidiary engages in the business of mortgage banking, which includes making, acquiring originating and/or servicing loans secured by first or second mortgages on one to four family owner-occupied residential properties. A Pennsylvania state-chartered commercial bank is authorized to engage in real estate lending pursuant to section 310 of the Banking Code. 7 P.S. § 310.

The Acquisition Company's sole function at this time is to hold 100% of the common stock of the Mortgage Company Subsidiary.

*Condition 2: The Bank must be able to prevent the Acquisition Company and the Mortgage Company Subsidiary from engaging in activities that do not meet the foregoing standard or be able to withdraw its investment.*

The Bank represents in the Notice that it is not aware of any impermissible activities undertaken by the Mortgage Company Subsidiary and is prepared (if required) to divest of the Bank's minority investment in the common stock of the Mortgage Company Subsidiary if the Mortgage Company Subsidiary engages in any impermissible activities. As indicated in the supplemental information provided to the Department and the Federal Reserve:

12. All the proposed shareholders of [Company] have agreed to restrictions which would prevent [Company] from engaging in any conduct impermissible for a state member bank. This is contained in the letter of intent in Section 4 and will also be reflected in the final agreements relating to this transaction. [Bank's] written commitment to divest itself of its investment in [Company] should [Company] become involved in any impermissible activity will be provided by supplemental response.

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Additionally, the Bank stated in the Notice that under the terms of the letter of intent, if the Mortgage Company Subsidiary engages in activities impermissible for a state member bank, the Bank has the right to give the Mortgage Company Subsidiary notice thereof and the Mortgage Company Subsidiary must cease either the impermissible activities or purchase all of the Mortgage Company Subsidiary's common stock held by the Bank at the fair market value of the stock, determined by an independent appraiser.

Based upon the revisions to the structure of this proposed transaction as set forth in counsel to the Bank's April 16, 1998, memorandum, the Bank's commitment to divest itself of the common stock of the Mortgage Company Subsidiary must be revised. The Bank must agree to divest itself of its investment in the Acquisition Company if either the Mortgage Company Subsidiary or the Acquisition Company engages in any activities which are not part of, or incidental to, the banking business.

*Condition 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 Acquisition Company or the Mortgage Company Subsidiary.*

The supplemental information provided to the Department and the Federal Reserve states:

14. The Bank's risk is limited to its initial investment. There will be no legal or contractual requirement for the Bank to invest additional capital in [Company]. If, contrary to the Bank's expectations, [Company] as a business is unsuccessful, then the Bank will write off the investment.

As a condition of the Department's approval, the Bank's liability must be limited, as a legal and accounting matter, and the Bank must not have open-ended liability for the obligations of either the Acquisition Company or the Mortgage Company Subsidiary.

*Condition 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 business.*

Finally, the Bank's 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 business. As stated in the Notice, the Bank is not engaged in mortgage banking as a general matter and does not offer non-conforming, government, secondary and adjustable rate mortgage loans or other innovations, such as streamlined loan documentation, which will be offered by the Mortgage Company Subsidiary. Therefore, the Mortgage Company Subsidiary is able to provide a lending service to the Bank's customers which is not directly available through the Bank. However, as stated in the supplemental information

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provided to the Department and the Federal Reserve, the Bank and the Mortgage Company Subsidiary will make necessary disclosures to ensure that the Bank does not violate the anti-tying provisions under federal law.

Furthermore, as discussed during our telephone conversation on April 22, 1998, the Department's approval is also conditional upon the following:

1. The Acquisition Company must not make any future acquisitions unless the Bank notifies and obtains the Department's prior written approval. Otherwise, the Department may require the Bank to divest itself of the investment in the Acquisition Company.
2. The Bank's investment in the Acquisition Company will be evaluated in the same manner as any other investment made by the Bank during a Bank examination by the Department. The Bank is required to obtain an annual evaluation of the investment to be reviewed by Department examiners during an examination. The Department reserves the right to classify the investment based upon the findings of the Department bank examiners.
3. Both the Acquisition Company and the Mortgage Company Subsidiary must be subject to the supervision and examination by the Department as deemed necessary by the Department.
4. Any necessary approvals must be obtained by the Bank from the federal banking regulators.<sup>3</sup>

The Department does not object, at this time, to the Acquisition Company's proposal to pledge 100% of the Mortgage Company Subsidiary common stock as collateral for the \$7.5 million loan to be extended by \_\_\_\_\_ Bank to the Mortgage Company Subsidiary.

The Department's analysis is based upon the facts and conditions as stated in this letter. Any change in the facts could result in a reversal of the Department's position. This letter states the Department's position regarding the issues discussed herein and may not be relied upon or construed as constituting legal advice.

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<sup>3</sup>Please be notified that the Bank may be required to obtain approval from the Federal Deposit Insurance Corporation pursuant to section 24 of the Federal Deposit Insurance Act, 12 U.S.C. § 1831a.

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Please feel free to contact me if you have any questions regarding the contents of this letter.

Very truly yours,

*Laurie S. Kennedy*

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Deputy Chief Counsel