

Department of the Treasury

Thrift Bulletin

TB 73a

Handbook: Thrift Activities

Subject: Asset Quality, Investment Securities



Section: 220

Investing in Complex Securities

Summary: This bulletin revises TB 73, which addressed a savings association's investment in trust preferred securities (TPSs). In TB 73, OTS established a supervisory limit for a savings association's investment in trust-preferred securities at 15 percent of total capital. This bulletin clarifies and amends some of the guidance in TB 73, and provides additional guidance on the underwriting of trust preferred securities and other complex investment securities. This bulletin replaces TB-73, and CEO Memorandum 130, "Underwriting the Purchase of Investment Securities," which are hereby rescinded.

For Further Information Contact: Your OTS Regional Office or William Magrini, Senior Project Manager, Supervision Policy, Washington, DC (202) 906-5744.

Thrift Bulletin 73a

Background

Certain securities have unique and varied features that require additional diligence on the part of savings association management who choose to invest in them. Some of these features raise supervisory concerns.

Since the issuance of TB-73, OTS has received questions from savings associations and securities dealers relating to trust preferred securities (TPSs), and other complex (or nonstandard) investment securities. Some questions have focused on OTS's requirement in TB 73 that a TPS be issued as a public offering (but not a private placement) to meet the regulatory requirement that the security must be able to be sold with reasonable promptness at a price that reasonably reflects fair value. Other questions have focused on the purchase of investment securities collateralized by pools of bonds, loans, or other securities such as TPSs, whether a savings association can purchase securities with ratings as to principal but not interest, and whether TB 73 applies to purchases of collateralized bond obligations (CBOs) backed by TPSs. These issues are addressed below.

Complex Investment Securities

In TB 13a, OTS defines a "complex security" to include any collateralized mortgage obligation, real estate mortgage investment trust, callable mortgage pass-through security, stripped mortgage-backed security, structured note, and any security not meeting the definition of an "exempt security." An exempt security includes non-callable, "plain vanilla" instruments such as mortgage pass-through securities, fixed rate securities, and floating rate securities. Complex securities also include securities such as a CBOs or collateralized loan obligations (CLOs), where the cash flows from the asset pools are divided into several tranches

Thrift Bulletin 73a

that have different repayment and collateral coverage and investment ratings, or that demonstrate other non-standard features such as having acceptable investment ratings for the principal part of the investment, but are unrated as to the payment of interest. Because of this complexity, a high degree of technical expertise is required to understand how these securities might behave under various interest rate, prepayment, and economic conditions. Moreover, because the market for many of these instruments is thin, it may be difficult to liquidate them at a price that reasonably reflects their fair value, should the need arise.

Complex securities, including TPSs, have unique features that merit further discussion; however, we will first discuss what OTS expects of thrift institution management when investing in securities.

Due Diligence in Purchasing Investment Securities

Savings associations have the responsibility to perform a thorough analysis of the quality of any security in which they invest. Prior to committing to purchase any investment security, management must first determine that the investment meets applicable regulatory and policy requirements, including:

- 12 CFR 560.40, Commercial Paper and Corporate Debt Securities
- 12 CFR 560.32, Pass-Through Investments
- TB 13a, Management of Interest Rate Risk, Investment Securities, and Derivative Activities

If the investment meets those requirements, management should then determine if the investment meets internal investment guidelines, is suitable for the institution, and is safe and sound. The board of directors and management should establish written investment policies and procedures that are consistent with safe and sound investment operations and conform to the objectives of the savings association's overall investment goals and objectives and the guidelines in OTS Thrift Bulletin 13a.

With respect to the purchase of individual securities, management should:

- Determine that the issuer, together with any guarantors, has the financial capacity and willingness to meet the repayment terms of the investment.
- Analyze the legal structure of the investment to determine that the institution has the authority to make such an investment.
- Analyze the expected performance of the issuer and any underlying assets. This should include a cash flow analysis prepared by the institution or a party engaged by the institution other than the seller/broker. The analysis should include the security's expected performance under various loss and interest rate scenarios, its expected effect on the overall interest rate risk profile of the institution, and a review of all covenants of any trust agreement that apply to the senior tranches.
- Analyze the entire security. If the security is divided into separate tranches with unequal payments, the analysis should include the effect of the payment priority on the investment purchased. If the security is pre-funded or includes a revolving period, the analysis should include a review of collateral investment parameters.

- Review and analyze the collateral managers, including their historical performance in managing such funds and their ability to make prudent investments, both when the fund is started and during any revolving period.
- Consider the liquidity and price volatility of the security. This should be based on a sensitivity analysis that reflects changes in credit quality, interest rates, and prepayment speeds.

In addition to the initial due diligence review of the investment, management has an ongoing responsibility to monitor the investment, including cash flows, collateral quality, and the performance of the underlying assets of the security at least quarterly to determine the effect of any changes to the institution's investment and adjust accordingly, if necessary. Management should fully document all of the above analyses. This memorandum reiterates OTS's due diligence requirements for investing in all securities. When a savings association makes an investment that does not meet the regulatory requirements, its investment practices will be subject to criticism, and OTS may require divestiture of such securities. In addition, securities should be appropriate for the institution and must be properly underwritten to be considered safe and sound investments.

General Considerations

When investing in complex securities, savings associations should take into account quality, marketability, interest rate risk, and classification factors.

Quality. Management is responsible for performing a thorough analysis of all securities in which it invests. Moreover, management's responsibility to perform a thorough analysis of a particular security increases proportionately with the complexity of the security and as the rating of the security moves down the rating scale. Institutions should determine the quality and long-term suitability of investments, especially with respect to complex securities with lower investment grades (for example, Moody's BBB) or securities that have received different ratings from different rating agencies. An institution's sole reliance on outside ratings for material purchases of complex securities is an unsafe and unsound practice. An institution should only use ratings and the accompanying analyses performed by nationally recognized rating agencies in conjunction with, and in validation of, its own underwriting processes. It should not use ratings as a substitute for its own thorough underwriting analyses.

Marketability. One requirement for savings associations that invest in corporate debt securities is that the securities must be able to be sold with reasonable promptness at a price that corresponds reasonably to their fair value (12 CFR 560.40(a)(2)(i)). TB 73 states that, to meet this requirement, a TPS should be issued as a public offering, because private placement offerings are sometimes thinly traded and a savings association may have difficulty selling such securities at a reasonable price. Since the issuance of TB 73, however, OTS has determined that there are some private placement securities that are subsequently traded in liquid and orderly markets and may meet OTS's marketability requirements. Beginning immediately, TPSs (or any other security) do not have to be sold through a public offering for savings associations to invest in them. Rather, a savings association must demonstrate that a viable market exists for the securities such that the regulatory marketability requirement is satisfied.

Interest rate risk. The high-risk nature of certain investment securities stems from their price volatility caused by changes in interest rates, market expectations, and the credit quality of the issuer. TB 13a establishes policies for savings associations to follow for interest rate risk limits, required systems for measuring

Thrift Bulletin 73a

and monitoring interest rate risk, stress testing, and record keeping. It also provides examiners with guidance on how to rate an institution's interest rate component of the CAMELS rating during examinations. Savings associations should follow the guidance in TB 13a when structuring their portfolios and when investing in complex and interest sensitive investment securities and derivative investment products.

Classification. Classification of investment securities is based on the credit risk and collectibility of interest and principal that the association has recorded as an asset. A decline in market value due to interest rate fluctuations is not a basis for classification. Classification of investment securities is subject to the "Uniform Agreement on the Classification of Assets." The interagency agreement states that, "Securities in grades below the four highest rating grades and unrated securities of similar value (quality) will be valued at market price and the depreciation will be classified Doubtful; the remaining book value will be classified Substandard. Depreciation on defaulted securities will generally be classified Loss, and the remaining book value will be classified Substandard. For non-investment grade corporate debt securities, any excess of amortized cost over fair value is classified Loss and the remaining book value is classified Substandard." When a savings association invests in investment grade securities that are subsequently downgraded to below-investment grade, the savings association should classify the investment pursuant to the "Uniform Agreement"; however, it is not automatically required to divest.

Holding below-investment grade securities exposes savings associations to risk of loss due to the significant credit risk of such securities compared with that of investment quality securities. The Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA) prohibits savings associations from purchasing below-investment grade corporate debt securities, including TPSs, CLOs, and CBOs, where the institution relies on the HOLA authority to invest in corporate debt securities as a basis for the investment. (If the pass-through authority of 12 CFR 560.32 is the basis for the investment, all assets securing the trust must be authorized investments for thrifts under HOLA.)

Issue-specific Considerations

Some investment securities have unique features that merit additional discussion. The need to properly assess investment securities before committing to purchase them is critical for structured notes or securities that have nonstandard ratings or where the repayment priority of the security being purchased is subordinated to other parts of the issue. For example, TPSs continue to be issued by many financial institutions and their holding companies. Also, some investment banking firms market new investment products backed by pools of commercial loans, corporate bonds, and even TPSs. The performance of these issues is based on the performance of the underlying pool of assets. These securities are referred to as collateralized loan obligations (CLOs) and collateralized bond obligations (CBOs), depending on the assets securing the issues. While high quality loans or investment securities are used to collateralize some of these issues, poor and marginal quality assets are used to collateralize others.

Collateralized Loan or Bond Obligations. Savings associations may invest in CLOs and CBOs through the pass-through authority to invest in the underlying assets of the collateralized pool (12 CFR 560.32) or through their authority to invest in corporate debt securities under HOLA (12 CFR 560.40). In either case, the savings association must meet the requirements of the respective regulation. Therefore, to use the pass-through authority for a CBO backed by corporate bonds, each underlying bond must meet the requirements of §560.40. If the issue is backed by commercial loans, the underlying loans must be underwritten in a safe and sound manner. If the investment is made using the corporate debt security authority, the issue must be investment grade and meet the marketability requirements as discussed above.

CLOs and CBOs are typically issued as structured notes, meaning the cash flows of the underlying collateral are divided into several separate tranches, each having yield, term, and other characteristics designed to appeal to different investors. For example, a CBO may be split into three different tranches: a senior note, a mezzanine (or junior) note, and a residual interest or “equity” certificate. The senior notes typically are overcollateralized by 10% to 25% and have repayment priority over the other notes in the issue with respect to both principal and interest. The mezzanine note is often collateralized at 100% to 105% of its initial value and has repayment priority over the equity certificates but is subordinate to the senior notes. The equity certificate is only a claim on the remaining cash flows and has no claim on the collateral until all obligations due to both the senior and mezzanine notes have been fully repaid.

CLOs typically have a revolving period and an amortization period. During the revolving period, principal payments are reinvested in additional assets in accordance with the terms of the agreement. During the amortization period, any principal payments are used to first repay the senior note holders in full, then any remaining principal is used to repay the mezzanine tranche investors.

Typically, the senior note is rated at the highest investment category. The mezzanine notes are generally rated at a lower investment grade. The residual interest certificates are generally not rated and are usually subordinated, not only to senior tranches, but also to expenses of the issuing trust. These residual tranches are difficult to value and are generally illiquid investments.

Split Ratings. While it is unusual, some securities may have a split rating, meaning that the principal may be given an investment grade rating, while the interest portion of the investment may be unrated or rated below investment grade. To make the residual tranche more marketable, the CLO issuer or trustee may swap the residual interest certificate for certificates guaranteed by a AAA-rated counterparty as to the principal amount at maturity. While the swap creates a guarantee of the principal at maturity, the amount guaranteed may be discounted to its present value if terminated early. In that respect, the guaranteed portion of the security is similar to a zero-coupon bond. Therefore, the credit support provided by the guarantor may only cover a fraction of the face amount of the certificate at purchase. Unlike zero-coupon bonds, which are discounted, however, these certificates are generally sold at par. To receive any interest on the certificates, investors must rely on the performance of the swapped asset (the residual certificates), which is not guaranteed.

Apparently, the motivation to purchase such certificates is the high yield projected if the CLO collateral pool (and thereby the reference asset) performs well. However, there is no guarantee of residual cash flows. Moreover, the certificates will not be in default if no cash flows are paid to the investors. These investments are highly speculative, and are clearly not intended to hedge interest rate risk or credit risk. Based on the general lack of supporting cash flow analysis for these investments, it is difficult to assess the likelihood that a particular return could be achieved. In essence, an institution should not be misled by split ratings where only a part of the security is either guaranteed or rated investment grade. Therefore, investments that are not fully rated as to both principal and interest do not meet OTS regulatory requirements.

Trust Preferred Securities. TPSs are non-perpetual cumulative preferred stock issued by a wholly owned trust subsidiary of a corporation (typically insurance companies and bank or savings and loan holding companies). Revenue from the sale of the TPSs is exchanged for junior subordinated debentures issued by the parent corporation. These debentures feature coupon payment and term to maturity identical to those of TPSs. Coupon payments on the TPSs have a specific dollar amount and term (typically 30 years). A unique feature of TPSs is the option of the issuer to defer any payments that come due to a future date (typically up to five years). Most issues provide that a contractual rate of interest must be paid on any deferred payment as long as it is outstanding.

Thrift Bulletin 73a

TPSs have some similarities to other investments and activities permissible for federal savings associations. Federal savings associations may invest in high quality corporate debt securities under section 5(c)(2)(D) of the Home Owners' Loan Act in compliance with 12 CFR 560.40. The junior subordinated debentures supporting TPSs may meet these requirements. Moreover, federal thrifts may make pass-through, equity-type investments in entities such as limited partnerships, trusts, and similar entities so long as the underlying investments are permissible for federal savings associations. See 12 CFR 560.32. The TPS structure has characteristics that may satisfy the pass-through requirements.

Unique risks associated with investment in TPSs. TPSs and similar instruments also display some characteristics that may present higher levels of risks than those traditionally associated with corporate debt securities or pass-through investments. First, the deferral option would allow an issuer to defer payments for up to five years without being in default, thus preventing holders from taking action against the issuer. Second, for some 30-year issues, the issuer has the ability to extend the maturity of the issue for an additional 20 years without approval of the TPS holders. Third, an institution may issue the securities, count them toward capital, then use the proceeds of the sale to purchase similar securities from other issuers—in effect, raising capital without substantively changing its financial condition. Fourth, many issuers of TPSs are bank holding companies, that, when rated, are rated in one of the two lower investment grades. This leaves little cushion should the financial capacity of the issuer decline. Finally, there is little data on the performance of TPSs over time, yet the securities have long maturities.

Investment authority and limits for TPSs. OTS has determined that, in general, TPSs that otherwise meet the requirements of corporate debt securities set forth at 12 CFR 560.40¹ are permissible investments for federal savings associations. Savings associations are, however, prohibited from purchasing TPSs or any other type of security from their parent holding company or any other affiliate.² Because of the considerable differences among these issues, and because their complex and varied nature, particularly the deferral option, poses higher risk than traditional corporate debt securities, savings associations, both federally and state-chartered, that invest in these or similar securities should ensure that such investments meet the following additional limitations and requirements. Savings associations should:

1. Limit their aggregate investment in TPSs and securities with similar attributes,³ to 15 percent of the institution's total capital;
2. Not enter into a formal or informal reciprocal agreement or understanding with another issuer or broker to purchase the securities of another issuer (also, 12 C.F.R. 563.81(d)(3) prohibits a thrift from selling subordinated debt directly or indirectly to another thrift unless the sale is approved by OTS);
3. Not invest in a security whose maturity can be unilaterally extended by the issuer beyond 30 years; and

¹ A thrift's investment in such securities: (1) must be able to be sold with reasonable promptness at a price that corresponds reasonably to their fair value; (2) must be rated in one of the four highest categories by a nationally recognized investment rating service at its most recently published rating before the date of purchase of the security; and (3) must meet the general lending limits of 560.93(c).

² 12 C.F.R. 563.41(a)(4).

³ For purposes of this bulletin, similar attribute means a security with the same risk characteristics as a TPS, such as a payment deferral option by the issuer and a subordinated debt status. A CBO backed by TPSs is also covered by the investment restrictions in this bulletin unless the institution can demonstrate that the credit support and rating afforded by the issuer remove the payment deferral and other concerns OTS has with respect to TPSs.

4. Only purchase TPSs in which management can demonstrate that the securities can be sold with reasonable promptness at a price that reasonably reflects fair value. This means that a ready market must exist for the securities. While publicly offered securities will generally meet these requirements, some private placement issues may not.

As with other types of corporate debt securities, OTS requires that institutions risk weight TPSs at 100% for risk-based capital purposes. TPSs are also subject to all other requirements or guidelines applicable to investment securities. This means that, among other things, institutions should ensure that their investment in TPSs is consistent with the institution's risk management and investment policies. Specifically, management should consider the overall effect of any investment in TPSs on the institution's levels of market, credit, liquidity, legal, operational and other risks of investment securities. Refer to Thrift Bulletin 13a, Management of Interest Rate Risk, Investment Securities, and Derivatives Activities, and the Federal Financial Institutions Examination Council Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities for additional guidance.⁴

Approval for additional investment. If you want to invest more than 15 percent of your capital in trust preferred or similar securities, you should obtain approval from your OTS Regional Office prior to your purchase or commitment. The Region will approve your request if it determines that the proposed investment poses no greater risk than an investment in a non-subordinated, investment grade, corporate debt security. The Region's determination will be based on the current rating of the security, the date of the rating, and whether other rating agencies have recently issued lower ratings. The Region will also consider the adequacy of information concerning the financial strength of the issuer, the due-diligence performed by the institution and the effect of the investment on your overall level of interest rate risk. OTS regional offices will carefully scrutinize TPSs with unusual characteristics. Requests for additional investment in TPSs where there is a supervisory concern will likely be denied. Examples include securities rated in the lowest investment grade, those with different ratings (where one firm rates the security as investment grade and another firm rates it as below-investment grade), and thinly traded securities (where the institution has not demonstrated that a viable resale market exists).

Capital treatment for issuers of TPSs. While this section of this bulletin addresses investment in TPSs and similar securities, questions have also arisen as to the capital treatment of such securities from an issuer's perspective. If a thrift holding company issues TPSs and invests the proceeds in the thrift, those funds may qualify as capital at the thrift level. Because any deferred payments on TPSs are cumulative, however, savings associations that issue TPSs directly may not count them towards their Tier 1 capital requirements. Moreover, savings associations are limited as to the amount of dividends that they may pay as a percentage of each year's income, depending on their capital level. Therefore, if a holding company were to issue obligations such as TPSs, where the proceeds would be invested in the thrift, it may require dividends from the thrift to make payments on the issue; payment of any dividends by the thrift to support such payments by the holding company may be limited by OTS's capital distribution rule (12 CFR 563.140-146).

Purchase of Non-investment Grade Securities as Loans

OTS has received questions as to whether a savings association could use its lending authority to purchase unrated or below-investment grade securities, including TPSs. The reason for some of the questions likely stems from pre-FIRREA legal opinions relating to a thrift's ability to invest in below-investment grade corporate debt securities. Moreover, the Office of the Comptroller of the Currency (OCC) recently issued a le-

⁴ 63 Fed. Reg. 20191 (April 23, 1998).

Thrift Bulletin 73a

gal opinion that banks may use their lending authority to invest in below-investment grade securities. However, the statutory lending authority and definition of a loan for national banks are different from such authority and definitions for savings associations under HOLA. Therefore, savings associations may not purchase non-investment grade or unrated corporate debt securities including TPSs.



*^{3/4} Richard Riccobono
Deputy Director*