Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #767
Februrary 1997
12 U.S.C. 24(7)90A
12 U.S.C. 24(7)92

January 9, 1997

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Dear [ ]:

This responds to your request, on behalf of [ ], [ ], [ ] ("Bank"), that the OCC interpret 12 C.F.R. Part 1 to permit the Bank to reclassify as a Type I security a variable rate obligation that the Bank recently purchased as a Type III security. The payment of the principal and a portion of the interest on the variable rate obligation is secured with Type I securities. Based on the information and representations provided, the Bank may treat the obligation as a Type I security subject to the requirements set forth in this letter.

<u>Overview of the Note</u>

The obligation ("Note") was issued by a newly created corporation ("Issuer") in an offshore offering exempt from registration under Rule 144A of the Securities Act of 1933. The Issuer is a special purpose [ ] corporation organized by private investors to engage in this transaction. The Note enables the Bank to indirectly participate in the commodities markets while limiting its downside risk.

The structure of the Note is complex and is discussed in detail below. However, the Note can be described generally as follows. The return on the Note includes both a fixed and a variable component. The fixed component is the minimum return the Bank could earn on the Note. The variable component is tied to the performance of an offshore commodity pool. The Issuer has secured the principal of the Note, the fixed return, and a portion of the variable return with an obligation of the Federal National Mortgage Association ("Fannie Mae"). The portion of the variable return earned to date that is not secured by the Fannie Mae obligation will be collateralized with cash or direct obligations of the United States and the amount of this collateral will be adjusted on a weekly basis. The variable return that could be earned in the future is secured up to an annual return of 6.84%, which is the amount of interest that will be paid on the Fannie Mae obligation.

Detailed Description of the Note

The Note represents a limited recourse debt obligation structured to yield a fixed annual amount of 2.9% (“Fixed Interest”) during the term of the investment, plus certain variable payments (“Variable Return”) linked to the performance of an offshore commodity pool (“Fund”) that trades in the international futures and forwards markets. The Variable Return consists of (i) the Variable Annual Payment equal to the discretionary dividends (if any) paid annually by the Fund, as measured in reference to the same amount of investment in the Fund as the principal amount of the Note, and (ii) upon maturity, the Supplemental Redemption Amount equal to the greater of (a) the product of 99.5% of the Fund’s net asset value (“NAV”) appreciation times the principal amount of the Note or (b) the amount necessary (if any) to generate a minimum 4% compounded annual rate of return after taking into account the Fixed Interest and the Variable Annual Payments actually paid by the Issuer. The Variable Annual Payments and the Supplemental Redemption Amount will be payable from the cash flow attributable to a swap arrangement (“Swap”) between the Issuer and a well-known creditworthy financial institution (“Swap Counterparty”). The Swap has certain periodic and termination payments linked to the Fund’s NAV. The Issuer makes fixed payments of 4% to the Swap Counterparty.

Using the proceeds from the issuance of the Note and a portion of its equity capital, the Issuer has purchased a Fannie Mae obligation (“Agency Bond”) with a fixed yield of 6.84% per annum and a maturity date that matches that of the Note. The Agency Bond has been pledged to secure the Issuer’s obligations arising under the Note and the Swap and is currently maintained in a custody account in the name of a federally supervised bank serving as collateral agent. The Agency Bond is sufficient for full repayment of the principal amount of the Note and payment of the Fixed Interest when due. Moreover, because of the netting arrangement under the Swap, in the event that the Swap Counterparty does not pay the Swap payments to which the Variable Return is linked, the Agency Bond will cover some or all (depending on amount) of the Variable Return in an amount up to the then outstanding payment of interest on the Agency Bond remaining after payment of the Fixed Interest due on the Note.

In addition, the Swap Counterparty has agreed to pledge periodically, on behalf of the Issuer, additional collateral (“NAV Collateral”) consisting of cash or direct obligations of the United States to secure the Issuer’s obligation to pay the Variable Return. Specifically, the Swap Counterparty is under agreement to fund an NAV Collateral account on the books of the collateral agent, which will be maintained separately from the Agency Bond. The funding agreement seeks to ensure that the market value of the NAV Collateral currently held, when measured on a weekly basis, is equal to the then prevailing value of the Supplemental Redemption Amount minus the mark-to-market value of a portion of the remaining future Swap payments to be made by the Issuer to the Swap Counterparty, plus or minus $75,000. The NAV Collateral thus held will be used to pay an unfunded portion of the Supplemental

Redemption Amount due on the Note, to the extent that the Issuer is not able to pay due to the Swap Counterparty's failure or inability to perform and the Agency Bond does not provide sufficient coverage.

As a result of the collateral arrangements described above, if the Swap Counterparty and the Issuer were to default, the most that the Noteholder could not realize is $75,000 (this amount is specified in the Swap Counterparty's funding agreement) plus the amount that the Variable Return exceeds the 6.84% return on the Agency Bond from the time of the default.

Analysis

You have requested that the OCC concur that the Note qualifies as a Type I security and therefore may be purchased by national banks in unlimited amounts, provided that the investment decision is consistent with safe and sound banking practice. You believe that, given the Note's variable rate features, the Note is sufficiently collateralized by Type I securities to qualify for treatment as a Type I security.

In determining whether an obligation can be treated as a Type I security, the OCC has looked to the underlying composition of the obligation. See, e.g., OCC Interpretive Letter No. 583 (April 27, 1992), reprinted in [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,404. The OCC has thus permitted banks to hold as Type I securities obligations that are fully secured by Type I securities as to all payments of principal and interest. The OCC has set forth an interpretation in 12 C.F.R. § 1.120(a), which provides that an obligation qualifies as a Type I security if it is "secured by an escrow fund consisting of obligations of the United States or general obligations of a State or a political subdivision, and the escrowed obligations produce interest earnings sufficient for the full and timely payment of interest on, and principal of, the obligation."[1] The OCC has interpreted "interest earnings" to mean "interest earnings and principal upon maturity." Investment Securities Letter No. 11 (November 26, 1986), reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,881.

OCC interpretations have not specifically addressed how variable rate obligations, such as the Note, should be secured by Type I securities to qualify for Type I treatment. You believe that a variable rate of interest on an obligation should not result in a requirement that the obligor secure its obligation at every possible rate that could be earned in the future.

In our view, the Note can be treated as a Type I security if the Bank complies with certain requirements outlined below. Type I treatment is appropriate because a review of the

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[1]The OCC has found certain other arrangements for holding the Type I securities in trust to be sufficient to satisfy the escrow fund requirement in 12 C.F.R. § 1.120(a). See, e.g., OCC Interpretive Letter No. 583 (April 27, 1992), reprinted in [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,404; Investment Securities Letter No. 11 (November 26, 1986), reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,881.

underlying composition of the Note indicates that it is functionally equivalent to a Type I security. Because of the collateral arrangements for the Note, the payment the Noteholder would receive in the event of default would be generally comparable to the payment the Noteholder would receive if it directly held the Agency Bond, which is a Type I security.[2] The principal, Fixed Interest, and a portion of the Variable Return on the Note are fully secured by the Agency Bond. In addition, the Variable Return earned to date is secured by the NAV Collateral. The NAV Collateral includes direct obligations of the United States, which are also Type I securities. 12 C.F.R. § 1.3(c). Because the proposed arrangement does not secure all the possible Variable Return that the Bank could earn in the future, the Bank must evaluate the payment and collateral mechanisms and conclude that they are reasonable to assure coverage of the principal and the interest that will be earned on the Note.

The Bank must also determine that the proposed arrangement is consistent with safe and sound banking practice, as required by 12 C.F.R. § 1.5. Section § 1.5(a) requires the Bank to consider certain risks presented by proposed activities and make sure that the particular activities it undertakes are appropriate for the Bank. The Bank also must evaluate the Note under OCC Advisory Letter 94-2, Purchases of Structured Notes. OCC Advisory Letter 94-2 provides that the determination of whether a particular instrument is appropriate depends on the bank's ability to understand, measure, monitor, and control that instrument's risk. Advisory Letter 94-2 requires banks to understand the risks of structured notes and be able to explain how those securities accomplish strategic portfolio objectives. The Bank's ability to purchase the Note as a Type I security in an amount in excess of 10 percent of its capital and surplus is contingent upon its ability to satisfy its examiner that the purchase is consistent with the standards in Advisory Letter 94-2.[3]

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[2]Part 1 provides that Type I securities "include obligations of the United States, general obligations of any State or political subdivision thereof and other obligations listed in paragraph Seventh of 12 U.S.C. § 24." 12 C.F.R. § 1.3(c). Paragraph Seventh includes in its list obligations of Fannie Mae.

[3]The Bank's examiner may also impose other prudential limits.

Conclusion

The Bank may treat the Note as a Type I security subject to the requirements set forth in this letter. If you have any questions, please contact me at (202) 874-5210.

Sincerely,

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Elizabeth S. Malone
Senior Attorney
Securities and Corporate
Practices Division