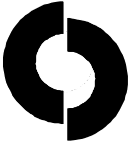

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #779
May 1997
12 U.S.C. 24(7)

April 3, 1997

[ ]
[ ]
[ ]
[ ]

Dear [ ]:

This is in response to your letter requesting an opinion from the Office of the Comptroller of the Currency that national banks may acquire for their own account beneficial interests in a privately offered investment fund that would invest in loans. We conclude that national banks may acquire such interests as securities, subject to a 5 percent aggregate investment limit and safe and sound banking practices, or as loan participations, subject to the requirements of Banking Circular No. 181 (Rev.) (August 2, 1984) ("BC-181").

Background

[ ] (" ") proposes to establish a fund that would invest solely in loans. Most of the loans would be high-yield, *i.e.*, their interest rate would reflect a large spread above market rates due to their credit quality. [ ] (" "), a department within [ ], would manage the Fund. The Fund would have capitalization of approximately $630 million at its inception, of which approximately $150 million would be provided by national and state-chartered banks, insurance companies, and other persons that qualify as "accredited investors" under the federal securities laws. The remaining $480 million in capitalization would come from the contribution of the high-yield loan portfolio currently managed by [ ]. In addition, [ ] has committed to participate in the future in additional loans originated or purchased by the Fund ($120 million). The minimum investment in the Fund would be $16 million. Because interests in the Fund would be sold through private placements, they would qualify for an exemption from registration under section 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(2). The Fund would not be subject to registration under the Investment Company Act of 1940, as it would have 100 or fewer investors. *See* 15 U.S.C. § 80a-3(c)(1).

The Fund would be organized as a Delaware business trust. [ ] would be the Fund's managing co-trustee and a Delaware-chartered bank affiliate would be the non-managing co-

trustee. The Fund's governing instrument, the Business Trust Agreement ("Agreement"), would provide that, upon dissolution of the Fund, each beneficial owner would receive a dollar amount equal to its *pro rata* interest in the Fund's net assets. The Agreement would further provide that all net cumulative profits of the Fund be allocated to investors *pro rata* on the basis of each investor's capital account until all investors receive a preferential compounded annual return (equal to a specified number of basis points in excess of the London Interbank Offered Rate). If there were any profits in addition to the preferential compounded annual return, [ ] would receive as a "special allocation" 20 percent of those excess profits; the remaining 80 percent of any additional profits above the preferential return would be allocated among the other investors *pro rata* on the basis of their capital accounts.

The Agreement would limit the Fund's activities to participation in primary and secondary loan markets. The Agreement would subject the Fund to supervision and examination by the OCC, the Board of Governors of the Federal Reserve System, and relevant state banking regulators. Investors in the Fund would be shielded from personal liability for the acts and obligations of the Fund since their liability as owners of beneficial interests in the Fund would be limited to the value of those interests.

The Fund's portfolio would hold loans from a variety of industries, including automotive, telephone, manufacturing, and health services. The Fund would invest no more than 10 percent of its portfolio in loans to any one business sector. The Fund would conduct monthly valuations of its loans at market value using third-party pricing sources. In the event it is not possible to determine market value, the Investment Manager would value loans at the lower of cost or fair value.

Banks investing in the Fund would receive information regarding the composition, credit quality, and performance of the loans in the Fund's portfolio. Banks would also be able to consult with [ ] concerning the Fund's investment decision-making. This information would include a list of each loan held in the Fund as of a specified date, a summary of the principal terms of each loan, the loan's credit rating, and information about the Fund's credit underwriting standards. On a quarterly basis, investors would receive information about the Fund's performance and changes in its composition.

Investors could liquidate their Fund holdings on a quarterly basis and would be required to provide at least 30 days prior notice of any redemption. Redemptions would be paid in an amount based on the market value of the Fund's portfolio as of the redemption date. During the first 18 months of the Fund's operations, quarterly redemptions would be subject to a "withdrawal fee". The amount of this fee would decrease over time. The organizers of the Fund have not yet established firm withdrawal fees but you state that the fee may be equal to 3 percent of the amount of the redemption during the first 6-month period, 2 percent during the second six-month period, and 1 percent during the third such period. Investors also would have the option of selling their interests to outside parties, subject to the consent of the managing trustee.

Discussion

National Bank Authority to Purchase Investment Securities

National banks may purchase investment securities subject to the limits of 12 U.S.C. § 24(Seventh) and 12 C.F.R. Part 1. The OCC defines "investment security" as a "marketable debt obligation that is not predominantly speculative in nature." 12 C.F.R. § 1.2(e). A security is not "predominantly speculative in nature if it is rated investment grade." When a security is not rated, it must be the credit equivalent of one that is rated investment grade. *Id.* The term "marketable" is defined to include a security that "[c]an be sold with reasonable promptness at a price that corresponds reasonably to its fair value." 12 C.F.R. § 1.2(f)(4). The OCC, however, also states in its regulations that, notwithstanding the definitions of "investment security" and "investment grade", "a national bank may treat a debt security as an investment security for purposes of [Part 1] if the bank concludes, on the basis of estimates that the bank reasonably believes are reliable, that the obligor will be able to satisfy its obligations under that security, and the bank believes that the security may be sold with reasonable promptness at a price that corresponds reasonably to its fair value." 12 C.F.R. § 1.3(i)(1). Such securities are subject to a 5 percent aggregate investment limit. *Id*. at § 1.3(i)(2). Banks purchasing securities permitted under Part 1 must adhere to safe and sound banking practices and consider, as appropriate, interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risk. *See* 12 C.F.R. § 1.5(a).

The OCC permits national banks to purchase for their own accounts investment company shares, provided that the investment company's portfolio consists exclusively of assets that a national bank could purchase directly. 12 C.F.R. § 1.3(h)(1). The OCC additionally may permit a national bank to invest in an entity that is exempt from registration as an investment company, provided that the portfolio of the company consists exclusively of assets that a national bank may purchase and sell for its own account. 12 C.F.R. § 1.3(h)(2). The OCC has permitted national banks to invest in limited partnerships and unregistered investment companies. *See* Interpretive Letter No. 687 (Sept. 5, 1995), *reprinted in* [1995 - 1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-002; Interpretive Letter No. 617 (March 4, 1993), *reprinted in* [1992 - 1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,457; Interpretive Letter No. 435 (June 30, 1988), *reprinted in* [1988 - 1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,659.

A crucial factor in the OCC's regulations on investment in investment company shares and in its prior interpretations is whether the investment company's underlying assets consist of bank-eligible investments. Among the activities that make up the business of banking are the discounting and negotiating of promissory notes, drafts, bills of exchange, and other evidences of debt, loaning money on personal security, and obtaining, issuing, and circulating notes. *See* 12 U.S.C. § 24(Seventh). Those powers are merely illustrative, however, and the list of bank powers contained in section 24(Seventh) does not constitute the full scope of the "business of banking". *See Nations Bank v. Variable Annuity Life Insurance Company*, 513

U.S. 251, ___, 115 S. Ct. 810, ___, 130 L. Ed. 2d 740, 749 (1995). National banking law limits the amount of total loans and extensions of credit by a national bank to a person that are not secured by certain specified collateral to 15 percent of the bank's capital and surplus. 12 U.S.C. § 84.

The OCC has issued guidance on national bank purchases of "junk bonds". *See* Banking Bulletin 85-12 (May 31, 1985). The OCC defines a "junk bond" as "a speculative security with limited marketability characteristics." *Id.* Generally, the OCC has barred purchases of junk bonds, stating that "[c]orporate debt securities used to finance corporate takeovers are generally considered to be predominantly speculative with limited marketability." *Id.* The OCC has, however, approved national bank purchases of sub-investment grade bonds in several contexts. *See, e.g.*, Interpretive Letter No. 703 (January 25, 1996), *reprinted in* [1995 - 1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-018 (purchase of unrated municipal revenue bonds to finance community development housing projects); Interpretive Letter No. 506 (Oct. 31, 1989), *reprinted in* [1990 - 1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,204 (purchase of bonds as part of developing country debt restructuring program); Interpretive Letter No. 470 (Feb. 1, 1989), *reprinted in* [1988 - 1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,694 (purchase of Brazilian Investment Bonds as part of developing country debt restructuring program).

National Bank Authority to Purchase Loan Participations

The OCC has issued extensive guidance on national bank purchases of loans and loan participations. *See* BC-181. The OCC requires banks to implement "satisfactory controls" over loan participations, including: 1) written lending policies and procedures governing those transactions; 2) an independent analysis of credit quality by the purchasing bank; 3) agreement by the obligor to make full credit information available to the selling bank; 4) agreement by the selling bank to provide available information on the obligor to the purchaser; and 5) written documentation of recourse arrangements outlining the rights and obligations of each party. *Id.* at 2. BC-181 notes that, "[t]o make a prudent credit decision, a purchaser conducts an independent credit analysis to satisfy itself that a loan, loan participation, or loan portfolio is a credit which it would make directly. The nature and extent of the independent analysis is a function of the type of transaction at issue and the purchaser's lending policies and procedures." *Id.* at 3. BC-181 also states that "[t]he acceptance by a purchaser of a favorable analysis of a loan issued by the seller, a credit rating institution, or another entity does not satisfy the need to conduct an independent credit analysis. A prudent purchaser may, however, consider such analysis obtained from the seller and other sources as factors when independently assessing a loan." *Id.*

Purchases of Interests in the Fund

National banks may purchase interests in the Fund as securities, subject to a 5 percent aggregate investment limit, or as loan participations. Part 1 provides for national bank

investments in unregistered investment companies so long as the underlying instruments in the portfolio are permissible investments for national banks. Part 1 does not require that the underlying assets of investment companies be limited to instruments labeled "securities". 12 C.F.R. § 1.3(h); Interpretive Letter No. 687, *supra*. Making loans is part of the business of banking, and national banks may hold shares of investment companies that invest in loans. *See* 12 U.S.C. § 24(Seventh).

Part 1 requires that an investment security be rated investment grade or the credit equivalent thereof. 12 C.F.R. § 1.2(e). Interests in the Fund would not qualify under Part 1 as "investment securities" if the credit quality of a portfolio consisting of high-yield loans were below investment grade. Even if interests in the Fund do not qualify as "investment securities", however, national banks may purchase limited quantities of interests in the Fund if they are able to conclude: 1) that the obligor could satisfy its obligations under the security (based on "reliable estimates"); and 2) that the security could be sold with reasonable promptness at a price that corresponds reasonably to its fair value. *See* 12 C.F.R. § 1.3(i). Under that standard, the OCC previously has permitted national banks to hold bonds to finance community development projects whose standards did not meet the credit quality requirements for investment securities. *See* Interpretive Letter No. 703, *supra*. The OCC concluded that national banks could purchase those instruments in an aggregate amount up to 5 percent of their capital and surplus.

In the instant situation, national banks would need to demonstrate that, due to the Fund's diversification and its investment standards, the Fund would perform in a manner consistent with the reliable estimates standard. That determination would require an analysis of the performance of the Fund's loans. The Fund's diversification should help ensure its overall performance. Investors in the Fund also should be able to sell their holdings with "reasonable promptness" at a "price that corresponds reasonably" to their fair value since redemptions could be made quarterly based on the interests' market value at the time of redemption.[1] Moreover, investors would be able to sell their interests to third parties, with the consent of the managing trustee, at any time. National banks also would need to consider risk factors enumerated in Part 1, such as liquidity risk, credit risk, compliance risk, and reputation risk, and satisfy themselves that they can manage such risks and that the investment is appropriate for them. *See* 12 C.F.R. § 1.5(a), *supra*.

In addition to purchasing interests in the Fund as securities under Part 1, national banks also may purchase such interests as loans or loan participations. *See* Interpretive Letter No. 506, *supra*. In order to rely on this authority, national banks would need to have sufficient information available to them to make the independent credit analysis required by BC-181. The nature and extent of the required independent credit analysis is a function of the

---

[1]Banking Bulletin 85-12 does not apply to this analysis as it addresses "junk bonds" issued to finance corporate take-overs. The high-yield loans in the Fund do not appear to be used for those purposes and therefore would not fall within the scope of that bulletin.

particular transaction. *Id*. at 3. Banks investing in the Fund would receive data from [ ] on the Fund's underwriting standards, and the principal terms, credit quality, and performance of loans in the Fund's portfolio. Banks would also be able to consult with [ ] on a continuous basis to evaluate the Fund's investment strategy and obtain information on the Fund's performance and composition. Rather than a full credit analysis of every underlying investment, national banks should be able to satisfy the requirements of BC-181 through an independent analysis of the performance information provided by the Fund and then by a quarterly review of the loans' performance data and credit ratings.

Conclusion

National banks may purchase interests in the Fund either as securities under the "reliable estimates" standard of Part 1, subject to a 5 percent aggregate investment limit, or as loan participations, subject to a 15 percent limit. Investments made under Part 1 are subject to the prudential considerations set forth in the rule. National banks contemplating investment in the Fund through the purchase of interests as loan participations should undertake an independent credit analysis as discussed above and evaluate whether the Fund's investment strategy and portfolio are consistent with their credit underwriting standards. If you have any questions, please do not hesitate to contact me at (202) 874-5210.

Sincerely,

/s/

Lee Walzer
Senior Attorney
Securities and Corporate Practices Division