

## Regulatory Bulletin

Section: 220  
RB 22Handbook: Thrift Activities  
Subjects: Below Investment/Noninvestment Grade Securities,  
Investment Securities, Capital Market Activities

December 6, 1989

**RESCINDED**  
Transfers of Below Investment/Noninvestment Grade  
Corporate Securities in Exchange for Qualified Notes

**Summary:** This Bulletin provides guidance to District personnel in 1) the approval process for applications to transfer noninvestment grade corporate debt securities in exchange for qualified notes as provided for in Section 28 (e) of the Federal Deposit Insurance Act (FDIA), as amended by the Financial Institutions Recovery, Reform, and Enforcement Act of 1989 (FIRREA) and 2) the examination review of resulting qualified notes held by thrift institutions.

**For Further Information Contact:** Your District Office or the Thrift Programs Division of the Office of Thrift Supervision, Washington, D.C.

Regulatory Bulletin 22Purpose

This bulletin alerts District personnel to the regulatory treatment of noninvestment grade corporate debt securities transferred in exchange for qualified notes.

Background

FIRREA mandates that thrift institutions and their subsidiaries, except qualified affiliates, divest noninvestment grade corporate securities, as soon as prudently possible and in all cases by July 1, 1994. According to FIRREA, noninvestment grade securities are those that, at the time of purchase, were not rated in one of the four highest rating categories (i.e., the four highest rating categories of AAA(Aaa), AA(Aa), A(A), and BBB(Baa)) by at least one nationally recognized statistical rating organization. For the purpose of this policy, unrated and privately placed securities are considered to be noninvestment grade securities. Specifically not subject to divestiture are investments in the stock or

bonds of a Federal Home Loan Bank or in the stock of the Federal National Mortgage Association; investments in mortgages, obligations, or other securities of the Federal Home Loan Mortgage Corporation pursuant to section 305 or 306 of the Federal Home Loan Mortgage Corporation Act; and investments in obligations, participations, securities, or other instruments issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association, the Student Loan Marketing Association, the Government National Mortgage Association, or any agency of the United States. All issuances previously reported on the Thrift Financial Report or to the Supervisory Agent as below investment grade/noninvestment grade securities will be considered as noninvestment grade for the purposes of this policy, as will any other securities that meet the definition of noninvestment grade securities but were reported otherwise.

Noninvestment grade corporate debt securities may be divested in one of two ways. They may be sold in the secondary market or they may, with approval of the Director, Office of Thrift Supervision (OTS), or designee, be exchanged for a qualified note.

Institutions Eligible to Exchange Noninvestment Grade Securities for a Qualified Note

Only those associations: 1) that submitted to the Director, OTS, by November 7, 1989 a notification of their intention to transfer noninvestment grade corporate debt securities; 2) that met their capital requirement on December 31, 1988; and 3) that continue to meet the capital requirement (or adopt and comply with a capital plan acceptable to the Director) are eligible to exchange noninvestment grade securities for qualified notes.

Mutual associations and stock associations not controlled by holding companies or those with holding companies controlling less than 80 percent of the shares of the insured savings association may not exchange noninvestment grade securities unless they change to an appropriate holding company corporate structure.

Qualified notes will be assigned a 100 percent risk weight as part of the thrift's risk based capital requirement.

Issuers of Qualified Notes

Institutions may exchange noninvestment grade corporate debt

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securities with any holding company that controls 80 percent or more of the shares of such insured savings association, or any company 80 percent or more of the share of which are controlled by such holding company. In no event, however, may the transferee be a bank holding company, an insured savings association, or a direct or indirect subsidiary of a bank holding company or insured savings association.

Because institutions holding qualified notes collateralized by noninvestment grade securities are still exposed to the risk of decreases in value of such collateral, the transferees of such notes should be sufficiently capitalized to withstand credit losses over the maturity of the notes. Generally, an allowance level equivalent to five percent of the outstanding qualified note would be considered sufficient for these purposes if the qualified note is collateralized adequately. In determining whether an allowance level less than five percent provides the necessary protection, the Director, or designee, may consider factors such as the extent of over-collateralization provided by the note, the length of the repayment period, and the ability of the holding company to guarantee the note, in addition to any other relevant considerations. In determining whether a holding company has sufficient capital to undertake a transfer, the Director, or designee, may take into account both the consolidated and non-consolidated capital position of the holding company.

## Terms of the Qualified Note

Guidelines for structuring the terms of the qualified note include:

- provides to the thrift the fair market value of the noninvestment grade security at the date of the exchange, including principal and interest;
- is on market terms. The market interest rate for the qualified note should be equivalent to the current yield of the specific issue exchanged (or the weighted average current yield of the total portfolio exchanged) based on the market value of the security (or portfolio) at the date of the exchange. In the case of non-cash pay bonds (e.g., PIKs and zero coupon bonds), the market interest rate for the qualified note should be equivalent to the yield to maturity. The Director, or designee, may permit the note to carry a lesser rate of interest if it is determined that adequate safeguards assuring repayment are in place so that the risk of default on the note is less than the risk of default on the underlying security; in no event, however, may the interest rate on the note be less than the insured savings association's borrowing rate for similar term funds;
- is repaid with periodic principal and interest payments paid at least annually utilizing a level payment amortization schedule. All proceeds from the sale of collateral before the maturity of the note must be used either to repay the note or to invest in other assets of equivalent value that serve as collateral;
- is at all times fully secured by collateral. In determining the adequacy of the collateral, the Director, or designee, may consider a) the noninvestment grade security transferred in exchange for the note or other collateral at least of equivalent value and b) the extent to which other collateral, along with the collateral provided in (a) above, meet the collateralization criteria in 23A and 23B of the Federal Reserve Act. The Director, or designee, at his/her discretion, may permit the note to carry less than 110 percent collateralization if he/she determines that the capital or allowance levels of the acquirer are adequate, the credit quality of the collateral is adequate, and the institution has monitoring systems in place to gauge the condition of the collateral. In no event, however, may the note be less than fully secured by collateral. Any decline in the fair market value of the collateral requires either the immediate infusion of additional collateral or the immediate pay down of the note by the issuer so that the note is fully secured by collateral. If the fair market value of the collateral declines and immediate steps are not taken by the issuer to further secure the note, the qualified note will be considered in default;
- is, at a minimum, fully guaranteed by the holding company;
- is repayable in full in cash over a period of time not to exceed 5 years from the date of transfer;
- the transfer represents a complete and effective divestiture of the security and further provides that in the event of a default by the note issuer, including failure to pay interest or principal when due, or failure to maintain collateral in accordance with the terms of the note, the savings institution shall seize the noninvestment grade security as collateral and liquidate it as soon as prudently possible and in all cases by July 1, 1994; and
- contains provisions that are acceptable to the Director, or designee, that prohibit encumbrance or impairment of the value of the collateral, including the perfection of collateral, the safekeeping of pledged collateral.

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eral, and the appropriate administration of liens, and permit the sale of the security if the proceeds are invested in equivalent value assets.

If at any time the thrift institution or its affiliate fails to comply with the specified terms of the note or any other provision affecting the transfer of the noninvestment grade corporate debt security, then exemptions from subsections (a), (b), and (c) of section 11 of the Home Owners' Loan Act and any other applicable provision of Federal or state law shall terminate.

## Procedures Necessary to Complete a Transfer of Noninvestment Grade Securities

Any eligible institution wishing to transfer noninvestment grade securities in exchange for a qualified note must submit an application to the appropriate District Director, OTS. For institutions that were controlled by a savings and loan holding company on or before August 8, 1989, the transfers must be effected by August 7, 1990 and such applications must be submitted by April 11,

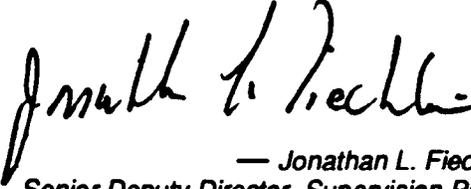
1990. For institutions that were not subsidiaries of a savings and loan holding company by August 7, 1989, the transfers must be effected by August 8, 1991 and such applications must be submitted by April 11, 1991. Any applications for the transfer of noninvestment grade corporate debt securities in exchange for a qualified note that raise significant issues of law or policy will be reviewed concurrently by Washington staff. The OTS staff will follow application processing guidelines as set forth in 12 C.F.R. Section 571.12 and AP-14-1.

The issuer of the qualified note must prove intention and ability to repay the qualified note by providing a credible plan for ensuring repayment. The application for the transfer of noninvestment grade securities in exchange for a qualified note should also contain:

- a detailed description of the non-investment grade security or securities to be transferred, including, at a minimum, the issuer, current coupon rate, maturity and sinking fund provisions, current market price,

sources or methods for determining market value, current yield, par value, book value, call date, call price, purchase date, unrealized gain/loss, rating, and duration;

- a statement describing the structure or proposed structure of the transferee, including amounts and sources of capital;
- consolidated and non-consolidated financial statements for the immediately preceding four quarters;
- a detailed description of the terms of the proposed qualified note, including, at a minimum, face value, interest rate, repayment schedule and dates, sources and amounts of collateral, a guarantee issued by the savings and loan holding company, capital or allowance levels designated for the note, a statement on the use of proceeds from the note collateral, the safekeeping of collateral, and provisions prohibiting the encumbrance or impairment of the value of the collateral.



— Jonathan L. Fiechter  
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