

Handbook: Thrift Activities  
Subject: Investment Securities

Section: 220  
TB 15

January 30, 1989

## Below-Investment-Grade Corporate Debt Securities

**RESCINDED**

*Summary:* This Bulletin provides a minimum framework for a program of safe and sound investment in below-investment-grade corporate debt securities. Thrifts and managers should observe these guidelines when developing and executing investment strategies. Such investment may not be prudent for institutions with inadequate capital or for those lacking investment expertise. This Bulletin replaces R-60, which is hereby rescinded.

*For Further Information Contact:*  
The FHLBank District in which you are located or the Policy Analysis Division of the Office of Regulatory Activities, Washington, DC.

### Thrift Bulletin 15

#### Introduction

FSLIC-insured institutions are permitted to invest in below-investment-grade corporate debt securities, defined as investments that are unrated or rated below the four highest investment grades and commonly labeled, "junk bonds". Under Federal Regulation 545.75(d), federally-chartered institutions may invest one percent of assets in commercial paper or corporate debt securities (credit ratings notwithstanding). In addition, Federal Regulation 545.46 allows federally-chartered institutions to invest in commercial loans, a term that includes corporate debt securities, in an amount up to ten percent of assets. As a result, federally-chartered thrifts may invest up to 11 percent of assets in below-investment-grade securities.

State-chartered thrifts and their service corporations may have different investment authority depending on specific state laws and regulations. All corporate debt securities are subject to the commercial loans-to-one-borrower limitations of Insurance Regulation 563.9-3, which limits the extension of commercial credit to any one borrower to fifteen percent of the thrift's unimpaired capital and surplus.

To control exposure to the risks associated with below-investment-grade securities, the following guidelines establish minimum standards for a well-managed program of investment.

#### Guidelines

##### A. Restrictions On Institutions That Fail To Satisfy Regulatory Capital Requirements Or That Warrant Special Supervisory Attention

Investment in below-investment-grade securities, (whether directly or through a mutual fund) or commercial loans may expose a thrift institution and, indirectly, the FSLIC to the risk of considerable loss due to the securities' significantly higher risk of credit loss as compared to traditional home mortgage lending. Consequently, the investment in such securities by FSLIC-insured institutions or FDIC-insured Federal savings banks that are insolvent or fail to meet minimum regulatory capital requirements is generally an unsafe and unsound practice unless approved by the Principal Supervisory Agent (PSA) or his designee in accordance with the conditions set forth below. The PSA may also limit the use of these products by other institutions that warrant special supervisory attention.

- 1) In conformance with Regulatory Bulletin 3a, "Policy Statement on Growth for Insured Institutions", insolvent institutions may not make any new investments in below-

investment-grade securities. The PSA may authorize an insolvent institution to retain existing investments in such securities only if such retention is in the best near-term interests of the FSLIC.

- 2) Solvent, but undercapitalized institutions (i.e., failing to meet minimum capital requirements) may make limited new investments in below-investment-grade securities only with the prior written approval of the PSA. The PSA may authorize such investments under the following conditions:
  - a) the District Bank has conducted a full review of the institution's business plan, investment policy, and management controls and is satisfied that the institution is capable of managing such investments without excessive risk to the institution's capital position; and
  - b) the investment program is conducted under terms and conditions approved by the District Bank.

The PSA may require insolvent institutions to divest existing holdings of below-investment-grade securities. Institutions failing their minimum capital requirement will be subject to a capital restoration plan that may, among other activities, require capital infusion or the shrinkage of high risk assets to ensure that

# Thrift Bulletin

TB 15

the institution returns to its required capital level.

## B. Investment Policy

The board of directors is responsible for establishing, maintaining, formally adopting, and administering a written investment policy that is consistent with the safe and sound operation of the insured institution. The policy should conform to the objectives of the institution's overall business plan. Prior to beginning an investment program, the board of directors should thoroughly analyze the risk and return parameters of these types of investments, compared with alternative investments, to support the asset allocation decision.

In general, the policy should:

- 1) set forth investment underwriting policies and procedures and require proper and complete documentation at all times to enable management, the board, and the examiners to evaluate the performance of the portfolio and whether the investment policy adopted by the board is being followed;
- 2) delegate appropriate decision-making authority and specify the extent of responsibilities;
- 3) require the retention of competent and qualified staff to monitor and analyze the portfolio on a continuous basis or require the retention of qualified consultants to manage the portfolio when in-house expertise is inadequate or when the size of the portfolio does not justify the hiring of in-house specialists. Such services should conform to R-Memorandum 70, "Investment Consultants"; and
- 4) require the directors to maintain oversight responsibility.

The policy should also establish specific investment authorities, dollar limitations, and standards with regard to:

- 1) whether the bonds are to be purchased for investment, sale or trading. If purchased for trading, provision should be made to ensure that they are sold to market at least quarterly. If purchased for sale, provision should be made to record the securities at the lower of cost or market. Investments in mutual funds consisting of below-investment-grade securities are required to be accounted for in accordance with SFAS No. 12 under generally accepted accounting principles;
- 2) the maximum permitted investment in relation to total assets, capital adequacy and regulatory restraints;
- 3) the proportion of lower rated, unrated and private placement securities in the portfolio;
- 4) diversification policies that establish maximum investment limitations for industries, issuers and affiliates, and individual issues; (i.e., Determine what percentage of the below-investment-grade securities portfolio should be allocated to any one industry, issuer, affiliate or issue.)
- 5) minimum issue size required for investment;
- 6) maximum holdings of any one issue or issuer's securities relative to each issue. (i.e., Determine what percentage of any one issue may be purchased. Generally, an institution is better positioned if it holds a small percentage of any single issue; its investment will be more liquid.);

- 7) the types of below-investment-grade securities in which investment may be made, (e.g., fixed coupon bonds, ascending rate bonds, zero coupon bonds, floating rate bonds or payment-in-kind bonds);
- 8) the desired target rate of return, stated as a spread over the return on a risk-free asset of comparable duration, and adjusted for expected default loss experience appropriate for a diversified portfolio of similar investments;
- 9) the expected effect on the institution's liquidity and interest rate risk; and
- 10) internal underwriting, documentation and monitoring policies and procedures including:
  - a) methodology for establishing loss allowances and classifying investments in accordance with Insurance Regulation 561.16c and Policy Statement 571.1a;
  - b) reporting frequency requirements to the board of directors to ensure regular board review and oversight;
  - c) reporting content requirements that at a minimum should include book value, market value, credit assessment and portfolio activity for all investments, including the notation of losses incurred on the sale of an investment, yield to maturity, unrealized gain or loss, rating changes (if any), information on defaulted or delinquent issues and any other information required to monitor compliance with the investment policy. (The reports should be sufficient in content to pro-

vide the basis for mark-to-market analysis.); and

d) an internal audit system.

The board of directors should review reports, including market analysis, at least quarterly (preferably monthly) to assess the performance of the portfolio and to gauge the adequacy of the institution's general and specific valuation allowances.

The board of directors should review the investment policy at least annually within the context of the institution's business strategy and amend the policy, if necessary, to adapt to any changes in the marketplace or in the institution's own operating objectives. Amendments should be formally approved by the board.

### C. Diversification Standards

The institution should adopt diversification standards to minimize the risks associated with below-investment-grade securities. The degree of diversification, however, may vary in accordance with the size of the portfolio. Elements that should be incorporated into an institution's investment policy include the following:

- 1) Market experience has indicated that a minimum portfolio of 20 issuers is generally necessary to achieve adequate diversification. Conversely, the thrift should ensure that its portfolio does not consist of so many issuers that it is unable to properly monitor their financial condition. For smaller portfolios, it may be more appropriate to consider investment in a well-managed mutual fund.
- 2) Exposure to a single issuer and any affiliate issuers should gen-

erally be limited to five percent of the total below-investment-grade portfolio. 3) The total cost of bonds of a single issuer combined with the total cost of bonds of affiliated issuers and all other extended credit may not exceed the loans-to-one-borrower limitations set forth in Insurance Regulation 563.9-3. An institution may not enter into a commitment to purchase securities that, when aggregated with other commitments to the issuer or its affiliates, cause the institution to violate the loans-to-one-borrower limitations.

- 4) Exposure to a single industry and related industries should generally be limited. A well-diversified portfolio would avoid excessive concentrations in industries that are vulnerable to the same economic factors.
- 5) An institution should generally maintain relationships with more than one broker/dealer to enable it to benefit from competitive quotations and diverse opinions and advice. The directors should require management to undertake a due diligence investigation into the background and reputation of each broker/dealer prior to entering into any transactions. All underwriters and brokers should be formally approved by the board of directors.
- 6) An institution may not invest in any below-investment-grade securities issued directly by, or indirectly associated with, a FSLIC-insured institution or nondiversified savings and loan holding company.
- 7) An institution's portfolio should consist primarily, if not exclusively, of obligations of domes-

tic U.S. corporate issuers.

### D. Underwriting Standards

#### 1) General

In addition to following the broad underwriting guidelines contained in R-63a, "Commercial Loans", institutions should analyze each investment on an ongoing basis taking into account the economic environment, industry characteristics and trends, and individual issuer characteristics. Analysis of the individual issuers should include a review of the company's:

- a) core business and its financial condition and vulnerability to adverse events, including operating trends, market share, exposure to principal customers or suppliers, and projected industry life cycle;
- b) cash flows;
- c) expected primary and secondary sources of repayment, including asset values;
- d) management quality and experience;
- e) stock market and senior debt securities' performance;
- f) expected effect of economic and industry trends on operations;
- g) contingent and off-balance sheet items; and
- h) projected debt service capability.

The analysis should include a review of the prospectus or offering circular and peer group comparisons and should be completed prior to acquisition of the bond. This analysis should be reviewed at least

# Thrift Bulletin

TB 15

quarterly thereafter. In cases where an issuer's outlook is favorable but the expected macroeconomic factors are not, the institution's investment decision should be supported by analysis that clearly justifies investment.

Institutions must maintain appropriate documentation of specific analyses for their own internal review processes and for subsequent review by examiners.

## 2) Mutual Funds

Current regulatory policy permits thrifts to invest up to five percent of assets in a single mutual fund holding below-investment-grade securities. Institutions investing in high-yield bond mutual funds are not expected to utilize each of the aforementioned specific underwriting standards in the evaluation of each security in the fund's portfolio. Thrifts, however, must document their evaluation and tracking of the fund's underwriting criteria, its portfolio constraints, past performance and management expertise. They should carefully analyze the fund's content, or investment holdings, before an investment decision is made and diligently monitor the fund's performance thereafter for consistency with the principles of safety and soundness as otherwise articulated in this bulletin.

The institution should also maintain documentation that it complies with the loans-to-one-borrower limitations by determining the prorated investments in each company based on its percentage ownership in the fund. This amount should be compared to the institution's own lending limits based on its regulatory capital. An institution should maintain a detailed listing of the fund's investments and should update it at least quarterly.

## E. Issue-Specific Analysis

Issue-specific analysis should cover

at least the following items:

- 1) rating of the issue, including any previous changes therein; (Institutions may also want to analyze the ratings of a company's other issues);
- 2) purpose of the financing and expected use of the funds obtained;
- 3) sources of repayment funds and the availability of collateral, (if any);
- 4) position of the security relative to the issuer's other current and potential liabilities (senior, subordinated, collateralized, etc.) and covenants of senior debt holders;
- 5) restrictive covenants. Except in circumstances where the insured institution otherwise has access to reliable periodic financial information, or where audited financial statements are required by law, institutions should invest only in securities that, by covenant, require quarterly and audited annual financial statements. Institutions should also evaluate covenants (or lack thereof) relating to restrictions on payments (dividends, stock repurchases, etc.) to common shareholders and other junior securities holders;
- 6) public offering or private placement and registration rights;
- 7) maturity and sinking fund provisions;
- 8) call redemption and refunding protection;
- 9) current yield, current yield-to-maturity, yield to call (if appropriate), and duration;
- 10) size of offering and representations of potential market mak-

ers. The institution should carefully evaluate the appropriateness of the probable liquidity of an issue with respect to the institution's overall portfolio and liquidity needs;

- 11) events that would trigger default;
- 12) merger and consolidation protection provisions; and
- 13) warrants and convertibility features (may be subject to the equity risk investment limitations of Insurance Regulation 563.9-8).

## F. Valuation Allowances

The board of directors and management should establish and maintain written policies and procedures concerning the determination of adequate general and specific valuation allowances. Such allowances must be adequate to absorb the estimated probable loss inherent in the portfolio at the end of each reporting period. The directors' policies should give consideration to the following factors:

- 1) the composition and volume of the portfolio;
- 2) the extent of and reasons for market depreciation in the portfolio, if applicable;
- 3) the degree of diversification by industry, issues, and issuers;
- 4) the relative levels and trends of delinquent and downgraded issues and of special mention, substandard, doubtful, and loss assets within the portfolio;
- 5) recent market and historical default loss rates on similar securities, including distressed exchange offers (typically, new equity or debt exchanged for a

# Thrift Bulletin

TB 15

troubled issue); and

- 6) the institution's own loss experience with these securities if an adequate performance record is available.

The determination of whether it is probable that specific assets have been impaired is facilitated by

- 1) periodic review of each asset by management;
- 2) documentation and analysis of current information concerning each issue and issuer, and an assessment of probable impairment, including any changes in

ratings if applicable;

- 3) identification of a continual rollover of a security's due date or the "payment" of interest through the issuance of additional securities;

- 4) evaluation of the issuer's ability to meet contractual obligations, including an analysis of current financial information;

- 5) review and documentation of the issuer's current market value relative to the market value of an index of similar securities;

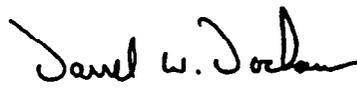
- 6) review and documentation of the relative market value of the issuer's common stock, other publicly traded securities, when

such information is available;

- 7) at least quarterly (and preferably monthly) reports to the directors on any rating changes affecting issues in the portfolio, delinquent or defaulted bonds, and any other investments that are closely monitored to determine impairment of asset value; and

- 8) at least quarterly reports to the directors regarding the necessary determination of amounts to be charged to the specific allowance for losses.

We request that institutions, examiners, and other users provide us with comments and suggestions as this bulletin is put into practice, for use in future revisions.

  
— Darrel Dochow, Executive Director

## FACT SHEET ON THRIFT BULLETIN 15

### Below-Investment-Grade Corporate Debt Securities

#### Purpose of the Guidelines

Provide a minimum framework for a program of safe and sound investment in below-investment-grade corporate debt securities, commonly known as junk bonds.

#### Background

- o FSLIC-insured institutions may invest in junk bonds.
  - Federally-chartered institutions may invest up to 11 percent of assets in junk bonds through authority contained in Sections 545.46 and 545.75(d) of the Federal regulations.
  - The investment authority of state-chartered thrifts and their service corporations is dependent on state law.
  - All junk bond investments are subject to the loans-to-one-borrower limitations contained in Insurance Regulation 563.9-3.
- o Investment by insolvent or undercapitalized thrifts is restricted.
  - Insolvent thrifts may not make any new investments in junk bonds. Existing investments may be retained only if the PSA determines such retention is in the best near-term interests of the FSLIC.
  - Undercapitalized thrifts may make limited new investments only with the prior written approval of the PSA.

#### Responsibilities of the Board of Directors

- o Establish and maintain a written investment policy that:
  - sets forth investment underwriting policies & procedures.
  - delegates appropriate decision-making authority.
  - requires the retention of qualified staff to manage the portfolio.
  - requires the directors to maintain oversight responsibility.

Possible Regulatory Concerns

- o Nonexistent or inadequate junk bond investment policy.
  - Inadequate diversification.
  - Poor underwriting.
  - Insufficient issue-specific analysis.
  - Inadequate valuation allowances.
  - Incompetent or inexperienced staff or consultants.