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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

July 3, 2001

**Interpretive Letter #912**  
**August 2001**  
**12 CFR Part 1**

Re: Bank Qualified Mutual Fund

Dear [ ]:

This letter responds to your request that the Office of the Comptroller of the Currency (“OCC”) determine that [ ] Funds’ proposed “Bank Qualified Mutual Fund” (“Fund”) is a permissible investment for national banks under 12 C.F.R. Part 1. Assuming the permissibility of a national bank’s investment in the Fund, you ask what investment limit and risk-weight a purchasing bank should apply to the investment, and whether the investment should be accounted for as “held-to-maturity” or “available-for-sale.”<sup>1</sup> For the reasons discussed below, and subject to the limitations described herein, we conclude that: [1] the Fund is a permissible investment for national banks under 12 C.F.R. § 1.3(h)(2),<sup>2</sup> [2] the risk-weight assigned to the Fund will depend on the composition of the Fund’s assets, but in no event will the minimum risk-weight be less than 20%, and [3] the investment can be accounted for as either a “trading” or “available-for-sale” asset.

## **I. Background**

The Fund will hold primarily general obligation and municipal revenue bonds that are designated by the Issuer as bank qualified.<sup>3</sup> The Fund will purchase municipal revenue bonds that are rated

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<sup>1</sup> You also question the capital gain or loss ramifications, and the tax-exempt status, of Fund investments. We express no view on these issues.

<sup>2</sup> If the Fund is an affiliate of the [ ] (“Bank”), any investments by the Bank and its affiliated depository institutions in the Fund would be subject to 12 U.S.C. §§ 371c and 371c-1.

<sup>3</sup> The Fund will purchase municipal bonds based upon an assessment of a bond’s relative value in terms of current yield, price, credit quality, and future prospects. The Fund also will monitor the continued creditworthiness of its

investment grade (*i.e.*, AAA/Aaa to BBB/Baa) at the time of purchase by independent rating agencies. The Fund also may buy non-rated municipal revenue bonds if the investment adviser judges them to be the equivalent of investment grade.

The Fund proposes to hold securities with five to fifteen year average maturities, with no more than 5% invested in any one issuer. The Fund plans to diversify across states and territories. It will use short term Treasuries or a Treasury Obligation Mutual Fund as the cash equivalent vehicle in the Fund.

## **II. Discussion**

Under 12 C.F.R. Part 1, a national bank may purchase for its own account shares in a mutual fund with a portfolio consisting of bank eligible investment securities.<sup>4</sup> National banks must conduct an independent review of a mutual fund's holdings to determine whether its portfolio consists of bank eligible investment securities and to determine applicable legal investment limitations under 12 U.S.C. § 24(Seventh) and 12 C.F.R. Part 1 ("Part 1"). The minimum risk-weight that a national bank can apply to a mutual fund investment is 20%. A national bank's intent or purpose in acquiring mutual fund shares determines whether the investment can be accounted for as a "trading" or "available-for-sale" asset.

### **A. National Bank Authority to Purchase Mutual Fund Shares**

A national bank may purchase for its own account, shares of an investment company, *e.g.*, a mutual fund with a portfolio consisting solely of obligations that are eligible for investment by a national bank.<sup>5</sup> Similarly, a national bank may invest in a fund that is exempt from registration as an investment company.<sup>6</sup>

Section 24(Seventh)<sup>7</sup> and Part 1 address national bank investments in bank-eligible investment securities. In general, Section 24(Seventh) permits national banks to purchase "investment securities" for their own account provided the aggregate par value of investment securities held by the bank issued by any one obligor does not exceed 10% of the bank's capital and surplus. The Section 24(Seventh) definition of investment securities includes "marketable obligations, evidencing the indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures,

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municipal investments, and analyze economic, political, and demographic trends affecting the municipal markets.

<sup>4</sup> National banks may purchase investment company shares for their own account based on other authorities, subject to applicable limits. See OCC Interpretive Letter No. 897 (October 23, 2000), *reprinted in* [2000-20001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-416.

<sup>5</sup> See 12 C.F.R. § 1.3(h)(1)(i).

<sup>6</sup> See 12 C.F.R. § 1.3(h)(2).

<sup>7</sup> See 12 U.S.C. § 24(Seventh).

commonly known as ‘investment securities.’” Part 1 defines an “investment security” as “a marketable debt obligation that is not predominantly speculative in nature.”<sup>8</sup>

Section 24(Seventh) and Part 1 exempt certain types of investment securities from the 10% investment limitation and permit a national bank to underwrite, deal in, purchase and sell those securities without quantitative limitation, *e.g.*, obligations issued by, or backed by the full faith and credit of, the U.S. Part 1, which classifies permissible national bank investment securities into several categories or types, classifies these investments as Type I investments.<sup>9</sup>

Section 151 of the Gramm-Leach-Bliley Act (GLBA),<sup>10</sup> amended Section 24(Seventh) to exempt municipal revenue bonds from the 10% investment limitation. To qualify for the exemption, a national bank must be “well capitalized” under prompt corrective action standards.<sup>11</sup> Specifically, Section 24(Seventh), as amended, permits national banks to deal in, underwrite, or purchase limited obligation bonds, revenue bonds, obligations that satisfy the requirements of section 142(b)(1) of the Internal Revenue Code of 1986, or other obligations issued by or on behalf of any State or political subdivision of a State, including any municipal corporate instrumentality of 1 or more States, or of a State.<sup>12</sup> Accordingly, municipal revenue bonds qualify under Part 1 as Type I investment securities for well-capitalized national banks. Indeed, the OCC has issued a notice of proposed rulemaking that, if adopted, would amend Part 1’s list of Type I securities to include municipal bonds as defined in the GLBA amendment to Section 24(Seventh) for well capitalized national banks.<sup>13</sup>

If a national bank is *not* well capitalized, it may purchase and hold municipal revenue bonds as Type III investment securities.<sup>14</sup> Part 1 permits a national bank to purchase and

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<sup>8</sup> 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, the security must be the credit equivalent of a security rated investment grade. *Id.*

<sup>9</sup> 12 C.F.R. §§ 1.2(i) and 1.3(a). You represent that, in addition to municipal revenue bonds, the Fund will hold only Type I investment securities.

<sup>10</sup> Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 151, 113 Stat. 1338, 1384 (1999) (codified at 12 U.S.C. § 24(Seventh)); *see also* 12 C.F.R. § 1.2(i)(5).

<sup>11</sup> Section 38 of the Federal Deposit Insurance Act, 12 U.S.C. § 1831*o*, states that “[a]n insured depository institution is ‘well capitalized’ if it significantly exceeds the required minimum level for each relevant capital measure.” 12 U.S.C. § 1831*o*(b)(1)(A). Section 38 also states that “[e]ach appropriate Federal banking agency shall, by regulation, specify for each relevant capital measure the levels at which an insured depository institution is well capitalized.” 12 U.S.C. § 1831*o*(c)(2). The OCC defines “well capitalized” for national banks at 12 C.F.R. § 6.4(b)(1).

<sup>12</sup> Footnote 10, *supra*.

<sup>13</sup> OCC Notice of Proposed Rulemaking, 66 *Fed. Reg.* 8178 (2001)(“NPR”). The comment period for the NPR closes on April 2, 2001.

<sup>14</sup> 12 C.F.R. § 1.2(k). The NPR, if adopted, will make clear that Type III securities include municipal bonds that do not satisfy the definition of a Type I security.

sell Type III investment securities, provided the aggregate par value of investment securities held by the bank issued by any one obligor does not exceed 10% of the bank's capital and surplus.<sup>15</sup> To qualify as a Type III security, a municipal revenue bond must be rated investment grade or, if not rated, the credit equivalent of investment grade, and marketable.<sup>16</sup> "Investment grade" means a security that is rated in one of the four highest rating categories by two or more nationally recognized statistical rating organizations (NRSRO) or by one NRSRO if the security is rated only by one NRSRO.<sup>17</sup> A security is the credit equivalent of a security rated investment grade if, after a sufficient analysis, the bank makes that determination. A debt security is "marketable," if it is: [1] registered under the Securities Act of 1933 ('33 Act),<sup>18</sup> [2] exempt from registration as a municipal revenue bond under the '33 Act;<sup>19</sup> [3] offered and sold under Rule 144A<sup>20</sup> and rated investment grade or is the credit equivalent thereof;<sup>21</sup> or [4] can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.<sup>22</sup>

National banks that hold mutual fund shares, the portfolios of which do not qualify as Type I securities,<sup>23</sup> must use reasonable efforts to calculate and combine its pro rata share of a particular security in the portfolio of each fund with the bank's direct holdings of that security.<sup>24</sup> A bank's direct holdings of a particular security and the bank's pro rata

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<sup>15</sup> 12 C.F.R. § 1.3(c); OCC Interpretive Letter No. 777 (April 8, 1997), *reprinted in* [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-204; OCC Interpretive Letter No. 781 (April 9, 1997), *reprinted in* [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-208.

<sup>16</sup> *See* 12 C.F.R. §§ 1.2(e) and (f)(2).

<sup>17</sup> *See* 12 C.F.R. §§ 1.2(d) and (g).

<sup>18</sup> *See* 15 U.S.C. § 77a, *et seq.*

<sup>19</sup> *See* 15 U.S.C. § 77c(a)(2).

<sup>20</sup> *See* 17 C.F.R. § 230.144A.

<sup>21</sup> *See* 12 C.F.R. § 1.2(f).

<sup>22</sup> *Id.* OCC regulations also state that, notwithstanding the definitions of "investment grade" and "investment security" in Part 1, a national bank may treat a debt security as an investment security, based on the bank's reliable estimates that the obligor will be able to satisfy its obligations under that security. *See* 12 C.F.R. § 1.3(i)(1). The "reliable estimates" provision allows a bank to invest in a below investment grade security, *i.e.*, in a category below one of a rating agency's four highest categories, provided that the bank satisfies itself that the securities may be sold with reasonable promptness at a price that corresponds reasonably to their fair value. *Id.* National banks may purchase securities under the "reliable estimates" standard in an aggregate amount no greater than 5% of their capital and surplus. *See* 12 C.F.R. § 1.3(i)(2). This limit applies against all securities in their portfolios acquired predominantly on the basis of reliable estimates, rather than on a per issuer basis. *Id.*

<sup>23</sup> The OCC has a long-standing policy of permitting a national bank to treat investments that are backed by Type I securities as Type I securities. *See Security Pacific v. Clarke*, 885 F.2d 1034 (2nd Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990); OCC Interpretive Letter No. 514 (May 5, 1990), *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,218; OCC Interpretive Letter No. 378 (April 24, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,602.

<sup>24</sup> *See* 12 C.F.R. § 1.4(e)(1).

interest in the same security in a mutual fund's portfolio may not, in the aggregate, exceed the investment limitation that would apply to that security. Alternatively, a national bank may elect not to combine its pro rata interest in a particular security in a mutual fund with the bank's direct holdings of that security if: [i] the fund's holdings of the securities of any one issuer do not exceed 5% of its total portfolio; and [ii] the bank's total holdings of the fund's shares do not exceed the most stringent investment limitation that would apply to any of the securities in the company's portfolio if those securities were purchased directly by the bank.<sup>25</sup> National banks must conduct periodic reviews to ensure that fund holdings do not exceed the most stringent investment limitation, relative to the bank's capital, that would apply to any of the securities if purchased directly.<sup>26</sup>

National bank management also must ensure that a particular mutual fund is an appropriate investment for the bank's investment portfolio.<sup>27</sup> A national bank's board of directors has the ultimate responsibility for deciding whether to invest in a mutual fund. Once that decision is made, the bank's board must review those holdings to determine whether a particular fund continues to be appropriate for the bank's investment portfolio.<sup>28</sup> 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.<sup>29</sup>

To the extent that the municipal revenue bonds held by the Fund are permissible investments for national banks under the criteria above, national banks may use their authority under Section 24(Seventh) and Part 1 to purchase Fund shares. If the purchasing bank is well capitalized under prompt corrective action standards, the investment may be treated as a Type I investment because the municipal revenue bonds and the other investments of the Fund are Type I investments. As a Type I investment, national bank purchases of the Fund's shares would not be subject to an investment limitation.

Conversely, if the bank purchasing Fund shares is not well capitalized, then the Fund shares could qualify as Type III investment securities, provided that applicable rating and marketability requirements are met. Under these circumstances, the investing bank could combine any direct holdings it had of a particular municipal revenue bond issuer with its pro rata interest by the same bond issuer held in the Fund's portfolio, subject to a 10% investment limitation. Alternatively, an investing bank could choose not to combine its Type III holdings in Fund with its direct holdings, if the Fund's holdings of any issuer do not exceed 5% of the Fund's total

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<sup>25</sup> See 12 C.F.R. § 1.4(e)(2).

<sup>26</sup> Banking Circular No. 220 (November 21, 1986) *Investment in Investment Companies Composed Wholly of Bank Eligible Investments*. ("BC-220").

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> 12 C.F.R. § 1.5(a).

portfolio, in which case the bank could not invest more than 10% of its capital in Fund, *i.e.*, the most stringent investment limitation applicable to the Fund under this scenario.<sup>30</sup>

## B. Risk-Weighting

For regulatory capital purposes, a national bank's asset portfolio is divided into four categories. Each category is assigned a risk-weight percentage that in theory reflects the risk level of the assets within that category.<sup>31</sup> In the case of mutual fund investments, the assets represent an indirect holding of a pool of assets that encompass more than one risk-weight within the pool.<sup>32</sup> Thus, the OCC generally allows a national bank to risk-weight its total investment in a mutual fund in the risk category appropriate to the highest risk-weighted asset the fund holds, consistent with the investment limits the fund incorporates into its prospectus.<sup>33</sup> Alternatively, the OCC affords national banks the option of assigning fund investments to different risk categories on a pro rata basis according to the investment limits in the fund's prospectus.<sup>34</sup> The OCC believes that it is more prudent to base risk-weight distributions on investment limits than on a fund's actual underlying assets because actual fund holdings can change significantly from day-to-day.<sup>35</sup>

Regardless of the risk-weighting method used, the minimum risk-weight that may be assigned to a fund is 20% -- a mutual fund has certain credit, transaction, and compliance risks that necessitate a risk-weight greater than zero percent.<sup>36</sup> Furthermore, if the bank assigns fund assets to risk categories on a pro rata basis, and the sum of the investment limits in the fund's prospectus exceeds 100%, the bank must assign the highest pro rata amounts of its total investment to the highest risk categories.<sup>37</sup>

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<sup>30</sup> If the Fund's municipal bond issue is not rated, not the credit equivalent of investment grade or rated below investment grade, a national bank may treat the Fund investment as an investment in investment securities if it concludes that: [1] the obligor could satisfy its obligations under the security (based on "reliable estimates") and [2] the security could be sold with reasonable promptness at a price that corresponds reasonably to its fair value. The purchasing bank's pro rata interest in the bonds would be combined with all of its other "reliable estimates" investments and subject to a 5% investment limitation. Conversely, provided that the Fund does not hold more than 5% of the securities of any one issuer, a national bank could include its entire investment in the Fund in its 5% "reliable estimates" investment limitation if the investment in the Fund satisfied the criteria described above.

<sup>31</sup> 12 C.F.R. Part 3, Appendix A. The risk-weights for national bank assets and off-balance sheet items, range from zero to 100%. The higher the risk-weight percentage, the riskier the asset category. For example, the risk-weight percentage for private loans is 100%, while the risk-weight percentage for government securities is 0%. Thus, no capital is necessary to offset government securities, while 100% of the specified minimum capital levels must be held against a bank's loans.

<sup>32</sup> *Id.*, at Section 3.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> 12 C.F.R. Part 3, Appendix A, Section 3; Final Rule, *Risk-Based Capital Standards*, 64 *Fed. Reg.* 10194 (March 2, 1999).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

Where a mutual fund is permitted to hold an immaterial amount of highly liquid, high quality securities ineligible for a preferential risk-weight, then those securities may be disregarded in determining the fund's risk-weight. However, if a fund engages in any activities that are speculative in nature or has any other characteristics that are inconsistent with the preferential risk-weighting assigned to the Fund's assets, then a national bank's investment in the fund will be assigned to the 100% risk-weight category.<sup>38</sup>

In summary, a purchasing bank may risk-weight its total investment in the Fund in the risk category appropriate to the highest risk-weighted asset the Fund holds, consistent with the Fund's investment limits as set forth in its prospectus. Otherwise, a purchasing bank may assign the Fund's investments to different risk categories on a pro rata basis according to the investment limits in the Fund's prospectus. In any case, the minimum risk-weight that may be assigned to a Fund is 20%.

### **C. Mutual Fund Accounting Classification**

Statement of Financial Accounting Standards Board No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("FASB 115") identifies the categories among which national banks must divide their securities holdings as held-to-maturity, trading, and available-for-sale, and provides a different accounting treatment for each category. FASB 115 permits a national bank to include a security in the held-to-maturity category only if the bank has "the positive intent and ability to hold the security to maturity." Trading securities are those debt and equity securities that a bank buys and holds principally for the purpose of selling in the near term. Securities in the available-for-sale category are securities a bank does not have the positive intent and ability to hold to maturity, yet does not intend to trade them actively as part of its trading account.

National banks that invest in mutual funds give up the ability to control whether the underlying securities are held-to-maturity. A national bank's intent or purpose in acquiring the Fund's shares will determine whether the investment should be accounted for as a "trading" or "available-for-sale" asset. When a national bank acquires mutual fund shares and at each subsequent reporting date, it must evaluate whether the investment should be accounted for as a "trading" or "available-for-sale" asset. If the mutual fund was bought principally to sell the investment in the near term, it should be accounted for as trading and marked to market through earnings. Otherwise, the mutual fund investment should be accounted for as an available-for-sale asset and recorded at its fair value.

### **III. Conclusion**

Under 12 C.F.R. Part 1, a national bank may invest in the Fund under its authority to invest in

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<sup>38</sup> *Id.*

mutual funds with portfolios that consist exclusively of bank eligible assets. Individual banks must determine the appropriate investment limits, based on the limitations of Section 24(Seventh), Part 1, and BC-220. The minimum risk-weight that a national bank can assign to the Fund is 20%. A national bank's intent or purpose in acquiring Fund shares will determine whether the investment should be accounted for as a "trading" or "available-for-sale" asset.

Our position is based on the facts and representations made in your letter and phone conversations, and any material changes in the facts or conditions may result in a different conclusion. We take no position on whether the proposed Fund is a permissible investment for State member banks. The OCC does not endorse specific investments and this letter should not be used in a manner that suggests otherwise. If you have any questions, please do not hesitate to contact me at (202) 874-5210.

Sincerely,

**-signed-**

Tena M. Alexander  
Counsel  
Securities & Corporate Practices Division