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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

March 11, 2002

**Interpretive Letter #930**  
**April 2002**  
**12 CFR 1**

Subject: Legal Permissibility of Purchasing Bonds Convertible into Equity

Dear [ ]:

This letter addresses whether the [ *State1* ] Federal branch of [ ] (“Bank”) legally purchased bonds convertible into equity. The purchase of the bonds was legally permissible under its Part 1 investment authority if the analysis the branch undertook at the time supported its conclusion that the bonds were the credit equivalent of investment grade and marketable, or if at the time it purchased the bonds, it underwrote them as loans in accordance with the standards of OCC Banking Circular 181.<sup>1</sup> In either case, the branch’s examiner-in-charge (“EIC”) or the appropriate supervisory office must find the branch’s conclusion or analysis to be sufficient, as documented by the branch prior to the purchase.

**I. Background**

In September 2000, the Bank and its [ *State1* ] and [ *State2* ] Federal branches (the “Branches”) engaged in three interrelated transactions: the purchase of bonds convertible into equity, an interest rate swap, and the sale of a call option on the bonds (collectively, the “Transactions”). This letter focuses on the bond purchase made by the [ *State1* ] branch (“Branch”).

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<sup>1</sup> The OCC requires banks to implement “satisfactory controls” over loans, 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. OCC Banking Circular No. 181 (Rev.) (August 2, 1984) (“BC-181”).

## **A. The Transactions**

The Transactions comprise a callable asset swap. An asset swap is a synthetic structure that enables an investor to purchase a fixed rate bond and hedge the interest rate risk by swapping the fixed rate payments for floating rate payments using an interest rate swap. The swap converts the asset yield on the bonds from fixed to floating. The sale of the call option enhances the yield. The asset swap is “callable” where, as here, the investor sells call options on the bond and the exercise of the options terminate the swap.

The callable asset swap is described in detail below.

### **(1) The Bonds**

[ *SPV* ], a Special Purpose Vehicle, issued \$550 million in 7-year Eurobonds, convertible after 12 months, at the option of the purchaser, into 8.708 million shares of [ *Co.* ] stock (“SPV Bonds”). The [ *SPV* ] Bonds are Eurodollar bonds quoted daily in the market. The convertible [ *SPV* ] Bonds bear a coupon rate of 4.75%. [ *Co2* ] (“*Co2*”) wholly owns [ *SPV* ] and guarantees the outstanding principal and accrued interest on the bonds. The Bank and the Branches purchased \$15 million of [ *SPV* ] Bonds. The [ *SPV* ] Bonds have embedded call options that give [ *SPV* ] the right to call the bonds. The bonds are not rated.

### **(2) The Interest Rate Swap**

Simultaneously with the purchase of the [ *SPV* ] Bonds, the Bank and its Branches entered into an interest rate swap with [ *Co3* ] (“*Co3*”). Under the interest rate swap, the Bank and the Branches pay [ *Co3* ] the fixed rate of 4.75%, the coupon rate of the bonds, semiannually. In return, [ *Co3* ] agreed to pay the bank a floating rate of LIBOR<sup>2</sup> plus a spread of 165 basis points, quarterly. The swap terminates in 7 years or when the [ *SPV* ] Bonds are called by [ *SPV* ], or upon [ *Co3* ]’ exercise of call options it purchased from the Bank and the Branches (described below). The Bank and the Branches secured their obligations under the swap by pledging the [ *SPV* ] Bonds to [ *Co3* ].

### **(3) The Call Options**

The Bank and the Branches, in connection with the purchase of the [ *SPV* ] Bonds and the interest rate swap, each sold a 7-year call option on the bonds to [ *Co3* ]. [ *Co3* ]’ exercise of the options entitles [ *Co3* ] to purchase all the [ *SPV* ] Bonds purchased by the Bank and its Branches at a predetermined “strike price.” If the [ *SPV* ] Bonds are called, exchanged or redeemed under the terms of the bonds, [ *Co3* ] is deemed to have exercised its call options and the swap terminates. Under the options’ terms, the Bank and its Branches are prohibited from converting the [ *SPV* ] Bonds into [ *Co.* ] stock while the Transactions remain outstanding.

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<sup>2</sup> “LIBOR” refers to the London Inter Bank Offered Rate, an interest rate that major international banks charge each other for large loans of dollars outside of the United States.

## **B. Analysis of the Transactions**

As discussed in Section II of this letter, a national bank may purchase debt securities as investment securities if the bonds are the credit equivalent of investment grade and marketable. The EIC must be satisfied that the information contained in the credit file demonstrates, at the time of the bond's purchase, appropriate support for the Branch to treat the bonds as the credit equivalent of investment grade and marketable.

Here, the Bank and the Branch analyzed the [ *SPV* ] Bonds in connection with the interest rate asset swap and call option, prior to the purchase of the bonds.<sup>3</sup> The Bank and the Branch approved the bond purchase based on [ *Co2* ]'s (the guarantor's) bond guarantee,<sup>4</sup> financial strength, and good market reputation and the convertibility of the [ *SPV* ] Bonds into [ *Co.* ] stock. Based on their financial review, the Bank and the Branches assigned the Transactions an internal rating of 3, equivalent to a long term debt rating of "A," prior to the purchase of the bonds. The bonds were also quoted daily in the market.

## **II. Applicable Law**

### **A. Permissible Purchases of Debt Securities**

National banks may purchase "investment securities" for their own account in an amount that generally may not exceed 10% of the bank's capital and surplus.<sup>5</sup> "Investment securities" are "marketable obligations, evidencing the indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures, commonly known as 'investment securities.'" An "investment security" is "a marketable debt obligation that is not predominantly speculative in nature."<sup>6</sup>

To qualify as a Type III security, a bond must be rated investment grade or, if not rated, the credit equivalent of investment grade, and marketable.<sup>7</sup> "Investment grade" means a

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<sup>3</sup> The bonds are not rated or registered under the federal securities laws. The Bank and the Branches considered the Transactions as "parts of one single transaction." Although the Bank and the Branches did a formal credit analysis on the issuer, they did not assign a credit rating on the bonds separate and apart from the interest rate swap they entered into with, and the call options they sold to, [ *Co3* ]. As a general matter, however, debt securities should be assigned their own separate rating.

<sup>4</sup> [ *Co2* ] provides an irrevocable, unconditional, and unsubordinated guarantee for all amounts payable under the bonds.

<sup>5</sup> 12 U.S.C. § 24(Seventh). The investment limitations in 12 C.F.R. Part 1 based on the capital stock and surplus of a national bank, when applied to a Federal branch or agency, refer to the dollar equivalent of the capital stock and surplus of the foreign bank, and all the business of the foreign bank and Federal branches is aggregated in determining compliance with the limitation. See 12 U.S.C. § 3102(b).

<sup>6</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>7</sup> See 12 C.F.R. §§ 1.2(e) and (f)(2).

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>8</sup> A security is the credit equivalent of a security rated investment grade if the bank, after a sufficient analysis, reaches that determination.<sup>9</sup> A debt security is “marketable” if it can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.<sup>10</sup>

A national bank may purchase a debt security as an investment security, even if the security does not qualify as a Type III security, based on the bank’s reliable estimates that the obligor will be able to satisfy its obligations under that security.<sup>11</sup> If so, the “reliable estimates” provision allows a bank to invest in a below investment grade security or one not determined to be the credit equivalent of investment grade, if the bank satisfies itself that the securities may be sold with reasonable promptness at a price that corresponds reasonably to their fair value.<sup>12</sup> National banks may purchase securities under the “reliable estimates” standard in an aggregate amount no greater than 5% of their capital and surplus.<sup>13</sup> This limit applies against all securities in their portfolios acquired on the basis of reliable estimates, rather than on a per issuer basis.<sup>14</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 the purchases present.<sup>15</sup> Any investments must be appropriate for national banks.<sup>16</sup>

Alternatively, a national bank may purchase and hold debt securities, including below investment grade securities, as loans under its general lending powers, consistent with safety and soundness considerations.<sup>17</sup> National banks that purchase debt securities under their lending authority must

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<sup>8</sup> See 12 C.F.R. §§ 1.2(d) and (h).

<sup>9</sup> See OCC Interpretive Letter No. 912 (July 3, 2001), *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-437.

<sup>10</sup> See 12 C.F.R. § 1.2(f)(4).

<sup>11</sup> See 12 C.F.R. § 1.3(i)(1).

<sup>12</sup> *Id.*

<sup>13</sup> See 12 C.F.R. § 1.3(i)(2).

<sup>14</sup> *Id.*

<sup>15</sup> See 12 C.F.R. § 1.5(a).

<sup>16</sup> *Id.*

<sup>17</sup> See OCC Interpretive Letter No. 834 (July 8, 1998), *reprinted in* [1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-288; OCC Interpretive Letter No. 833 (July 8, 1998), *reprinted in* [1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-287; OCC Interpretive Letter No. 600 (July 31, 1992), *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,427; OCC Interpretive Letter No. 579 (March 24, 1992), *reprinted in* [1991-1992

comply with the lending limit restrictions in 12 U.S.C. § 84<sup>18</sup> and generally may not purchase them in an amount exceeding 15 percent of the bank's capital and surplus.<sup>19</sup> Bank purchasers also must adhere to the prudential standards of BC-181, to the extent applicable, including the requirement that they perform an independent credit analysis of the loans to satisfy themselves that the credits meet their own credit standards.<sup>20</sup>

### **III. Discussion**

#### **A. Determination of Credit Equivalent of Investment Grade and Marketable**

To qualify as a Type III security, a bond must be rated investment grade or, if not rated, the credit equivalent of investment grade and marketable. The [ *SPV* ] Bonds are not rated. Accordingly, the Bank and its Branches could only purchase the [ *SPV* ] Bonds as Type III securities, subject to a 10% limitation, if, at the time of purchase, they determined the bonds were the credit equivalent of investment grade and marketable. The Branch's EIC or supervisory office must find the Branch's conclusion or analysis to be sufficient, as documented by the Branch at the time of purchase. The subsequent sale of call options on the bonds by the Bank and the Branches would not affect a determination that the bonds were marketable.

#### **B. The Debt Securities' Conversion Feature is not Prohibited by Part 1**

National banks generally may not purchase investment securities that are convertible into equity at the option of the issuer.<sup>21</sup> However, a national bank may acquire convertible debt securities, provided that it disposes of the securities before the date the conversion option comes into effect.<sup>22</sup> A national bank also may purchase debt securities convertible to equity securities at the bank's option where the bank does not exercise the conversion feature.<sup>23</sup>

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Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,349; OCC Interpretive Letter No. 182 (March 10, 1981), *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,263.

<sup>18</sup> The lending limits in 12 U.S.C. § 84 based on the capital stock and surplus of a national bank, when applied to a Federal branch or agency, refers to the dollar equivalent of the capital stock and surplus of the foreign bank, and all the business of the foreign bank and Federal branches is aggregated in determining compliance with the limitation. *See* 12 U.S.C. § 3102(b).

<sup>19</sup> *See* OCC Interpretive Letter No. 834, *supra*; OCC Interpretive Letter No. 833, *supra*; OCC Interpretive Letter No. 579, *supra*.

<sup>20</sup> *See* OCC Interpretive Letter No. 663 (June 8, 1995), *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,611; OCC Interpretive Letter No. 579, *supra*.

<sup>21</sup> *See* 12 C.F.R. § 1.6.

<sup>22</sup> OCC Interpretive Letter No. 359 (April 9, 1986), *reprinted in* [1985-1987 Transfer Binder] CCH ¶ 85,529; OCC Investment Securities Letter No. 55 (August 5, 1991), *reprinted in* [1991-1992 Transfer Binder] CCH ¶ 83,328.

<sup>23</sup> If an option is not exercised, there is no conversion and no resultant equity holdings. The OCC similarly has permitted national banks to own real estate as principal in various contexts, notwithstanding the general prohibition in 12 U.S.C. § 29 against banks owning real property. OCC Corporate Decision No. 99-07 (March 26, 1999)

The Branch would not be prohibited from holding the [ *SPV* ] Bonds on the basis of the conversion feature because the conversion feature is in its control. Moreover, because the Branch is prohibited from converting the bonds into equities under the callable asset swap, the convertibility of the bonds is not at issue.

### **C. The Bonds May be Purchased as Loans**

The Branch may rely on its lending authority to hold the bonds if it underwrote them as loans at the time of purchase, in accordance with the standards of BC-181. The Branch's EIC or appropriate supervisory office must find the Branch's conclusion or analysis under those standards to be sufficient, as documented by the Branch at the time of purchase.

### **IV. Conclusion**

The Branch's purchase of the bonds was legally permissible under its Part 1 investment authority if the analysis the Branch undertook at the time supported its conclusion that the bonds were the credit equivalent of investment grade and marketable, or if at the time it purchased the bonds, it underwrote them as loans in accordance with the standards of BC-181. In either case, the Branch's EIC or the appropriate supervisory office must find the Branch's conclusion or analysis to be sufficient, as documented by the Branch at the time of purchase. The Branch must clearly document in its credit files the authority it relies on to make debt acquisitions at the time of purchase.

I trust the foregoing is responsive to your inquiry. If you have additional questions, please do not hesitate to contact Tena M. Alexander, Special Counsel, Securities & Corporate Practices Division at (202) 874-5210.

Sincerely,

/s/

Julie L. Williams  
First Senior Deputy Comptroller and Chief Counsel

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(ownership of real property interests as incidental to permitted financing transactions); OCC Conditional Approval Order No. 295 and OCC Corporate Decision No. 98-17 (March 23, 1998) (same); OCC Interpretive Letter No. 806 (October 17, 1997), *reprinted in* [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,253 (ownership of real property in a net lease transaction that is a loan substitute for Islamic customer); 12 C.F.R. §1.100(b) (municipal leases). In addition, the OCC has permitted national banks to own various types of personal property in order to engage in lease-financing activities. *See* 12 C.F.R. § 23.20; *See also*, Letter from Robert Herman, Deputy Comptroller (October 4, 1994) (unpublished) (ownership of an interest in trust that purchased hydrocarbon producer payments in connection with financing transaction). In all these contexts, the prohibitions otherwise applicable to ownership of these assets by a national bank as principal are not applicable because owning the asset is deemed necessary for the national bank to engage in a permissible banking activity or transaction.