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Office of Thrift Supervision **November 04, 1998**

Department of the Treasury

Thrift Bulletin

TB 73

Handbooks: **Thrift Activities** **Section: 220**

Subject: **Asset Quality, Investment Securities**

Trust Preferred Securities

RESCINDED

Summary: This bulletin addresses a savings association's investment in trust preferred securities or similar securities. Savings associations (you) may invest in trust preferred securities or similar securities in accordance with the limitations established in 12 C.F.R. 560.40. Due to the unique nature of these securities, however, you should limit such investments to 15 percent of your total capital. If you want to invest more than 15 percent of your capital in trust preferred or similar securities, you must obtain approval from your OTS Regional Office prior to your purchase or commitment.

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Thrift Bulletin 73

Trust Preferred Securities

Background. OTS has received requests from savings associations and securities dealers asking if thrifts may invest in trust preferred securities (TPSs). TPSs are non-perpetual cumulative preferred stock issued by a wholly owned trust subsidiary of a corporation (typically insurance companies and bank or savings and loan holding companies). Revenue from the sale of the TPSs is exchanged for junior subordinated debentures issued by the parent corporation. These debentures feature coupon payment and term to maturity identical to those of TPSs. Coupon payments on the TPSs have a specific dollar amount and term (typically 30 years), however, in some cases, the issuer has the right to extend the maturity for another 10- to 20-year period. A unique feature of TPSs is the option of the issuer to defer any payments that come due to a future date (typically up to five years) as long as the current values of the two payments are identical at the date of deferral (meaning interest must be paid on any deferred payment as long as it is outstanding).

The information available to OTS in this developing area indicates that TPSs have some similarities to other investments and activities permissible for federal savings associations. Federal savings associations may invest in high quality corporate debt securities under section 5(c)(2)(D) of the Home Owners' Loan Act in compliance with 12 CFR 560.40. The junior subordinated debentures supporting TPSs may meet these requirements. Moreover, Federal thrifts may make pass-through, equity-type investments in entities such as limited partnerships, trusts, and similar entities so long as the underlying investments are permissible for federal savings associations. See 12 CFR 560.32. The TPS structure has characteristics that may satisfy the pass-through requirements.

Unique risks associated with investment in TPSs. TPSs and similar instruments also display some characteristics that may present higher levels of risks than those traditionally associated with corporate debt securities or pass-through investments. First, the deferral option would allow an issuer to defer payments for up to five years without being in default, thus preventing holders from taking action against the issuer. Secondly, for some 30-year issues, the issuer has the ability to extend the maturity of the issue for an additional 20 years, without approval of the TPS holders. Thirdly, an institution may issue the securities, count them toward capital, then use the proceeds of the sale to purchase similar securities from other issuers—in effect, raising capital without substantively changing its financial condition. Fourthly, many issuers of TPSs are bank holding companies, that, when rated, are rated in one of the two lower investment grades. This leaves little cushion should the financial capacity of the issuer decline. Finally, there is not a lot of data on the performance of TPSs over time, yet the securities have long maturities.

Investment authority and limits for TPSs. At this time, OTS believes that TPSs that otherwise meet the requirements of corporate debt securities set forth at 12 CFR 560.40 [1] are permissible investments for federal savings associations. You are, however, prohibited from purchasing TPSs or any other type of security from your parent holding company or any other affliate.[2] Because this area is still developing, and the risks associated with these securities, particularly the deferral option, are higher than traditional corporate debt securities, OTS believes that all savings associations, both federally and state-chartered, that invest in these or similar securities should ensure that such investments meet the following additional limitations and requirements:

1. You should limit your aggregate investment in TPSs and securities with similar attributes, to 15 percent of total capital;
2. You should not enter into a formal or informal reciprocal agreement or understanding with another issuer or broker to purchase the securities of another issuer (also, 12 C.F.R. 563.81(d)(3) prohibits a thrift from selling subordinated debt directly or indirectly to another thrift unless the sale is approved by OTS);
3. You should not invest in a security whose maturity can be unilaterally extended by the issuer beyond 30 years; and
4. You should only purchase TPSs that are public offerings (because of liquidity concerns).

As with other types of corporate debt securities, TPSs will be 100% risk-weighted, for risk-based capital purposes. TPSs are also subject to all other requirements or guidelines applicable to investment securities. This means that, among other things, you should ensure that your investment in TPSs is consistent with your institution's risk management and investment policies. Specifically, you should consider the overall effect of any investment in TPSs on your levels of market, credit, liquidity, legal, operational and other risks of investment securities. You may refer to TB Bulletin 13a (Management of Interest Rate Risk, Investment Securities, and Derivatives Activities) or the Federal Financial Institutions Examination Council Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities for additional guidance.[3]

Required approval for additional investment. If you want to invest more than 15 percent of your capital in trust preferred or similar securities, you must obtain approval from your OTS Regional Office prior to your purchase or commitment. The Region will approve your request only if it determines that the proposed investment poses no greater risk than an investment in a non-subordinated, investment grade, corporate debt security. The Region's determination will be based on the current rating of the security, the date of the rating, and whether other rating agencies have recently issued lower ratings. The Region will also consider the adequacy of information concerning the financial strength of the issuer, the due-diligence performed by the

[1] A thrift's investment in such securities: (1) must be able to be sold with reasonable promptness at a price that corresponds reasonably to their fair value; (2) must be rated in one of the four highest categories by a national recognized investment rating service at its most recently published rating before the date of purchase of the security; and (3) must meet the general lending limits of 560.93(c).

[2] 12 C.F.R. 563.41(a)(4).

[3] 63 Fed. Reg. 20191 (April 23, 1998).

institution and the effect of the investment on your overall level of interest rate risk. Requests for additional investment in TPSs having the two lowest investment grades are likely to be denied.

This bulletin is effective immediately. If your investment in TPSs or similar securities exceeds the limitations set forth in this bulletin, you should submit a plan to the Regional Office to reduce your investment in a timely manner to a level acceptable to the Regional Director or request additional investment authority.

Capital treatment for issuers. While the primary purpose of this bulletin is to address whether thrifts may invest in TPSs or similar securities, questions have also arisen as to the capital treatment of such securities from an issuer's perspective. If a thrift holding company issues TPSs and invests the proceeds in the thrift, those funds may qualify as capital at the thrift level. Because any deferred payments on TPSs are cumulative, however, savings associations that issue TPSs may not count them towards their Tier I capital requirements.

OTS will continue to evaluate the performance of TPSs over time and may issue additional guidance regarding investment in these securities at some point in the future.