DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Parts 1 and 7

[Docket No. 96–26]

RIN 1557–AB37

Investment Securities

AGENCY: Office of the Comptroller of the Currency, Treasury.

ACTION: Final rule.

SUMMARY: The Office of the Comptroller of the Currency (OCC) is clarifying and updating its rules that prescribe the standards under which national banks may purchase and sell, deal in, and underwrite securities. This final rule is another component of the OCC's Regulation Review Program, a project designed to review, modernize, and simplify OCC regulations and reduce unnecessary regulatory burdens on national banks. The final rule reorganizes the regulation by placing related subjects together, clarifies certain areas, and updates various provisions to address market developments and to incorporate significant OCC interpretations, judicial decisions, and statutory amendments.

EFFECTIVE DATE: December 31, 1996.

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SUPPLEMENTARY INFORMATION:

Background

Part 1 has historically prescribed the limitations and restrictions on a national bank's purchase of investment securities for its own account. Part 1 also addresses a national bank's ability to purchase and sell, deal in, and underwrite certain investment securities. The part 1 limitations on these activities are based on the Banking Act of 1933, section 16, Pub. L. 73–66, 48 Stat. 184 (codified as amended at 12 U.S.C. 24(Seventh)), and vary according to the characteristics of the security.

In the past, part 1 grouped the securities identified in 12 U.S.C. 24(Seventh) into three categories, Types I, II, and III securities. More recently, the Secondary Mortgage Market Enhancement Act of 1984, (SMMEA) [1] and the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI) [2] amended 12 U.S.C. 24(Seventh) and removed quantitative limits on national banks'' purchases of certain types of mortgage- and small business-related securities, subject to regulations prescribed by the OCC.

On December 21, 1995, the OCC published a notice of proposed rulemaking (60 FR 66152) (proposal) to revise part 1 and implement the changes required by CDRI and SMMEA. The proposal sought to implement the goals of the OCC's Regulation Review Program by updating and streamlining the regulation and eliminating requirements that imposed inefficient and costly regulatory burdens on national banks. The proposal also sought to implement the amendments made by SMMEA and CDRI and to update various provisions to address market developments and to incorporate significant OCC interpretations and judicial decisions.

In the proposal, the OCC added two new classifications of securities to characterize the changes made by SMMEA and CDRI and to reflect developments in national banks'' treatment of their assets. Specifically, the proposal added a new category of securities, Type IV securities, that are defined as certain types of asset-backed securities identified in SMMEA and CDRI, which are exempt from the 10 percent investment limitation of 12 U.S.C. 24(Seventh). Type IV securities are: (1) residential and commercial mortgage-related securities offered and sold pursuant to section 4(5) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77d(5); (2) residential and commercial mortgage-related securities described in section 3(a)(41) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78c(a)(41); and (3) small business-related securities as defined in section 3(a)(53)(A) of the Exchange Act, 15 U.S.C. 78c(a)(53)(A).

The proposal also added Type V securities, which are investment grade securities that are backed by pools of assets composed of obligations in which a national bank may invest directly.

In addition to adding Type IV and Type V securities, the proposal refined the definitions and limitations imposed on the three existing types of securities. Finally, the proposal restructured part 1 to make it easier to read and apply.

[1] Sec. 105(c), Pub. L. 98–440, Title I, 98 Stat. 1691 (codified as amended at 12 U.S.C. 24(Seventh) (1984)).

[2] Pub. L. 103–325, 108 Stat. 2160 (1994).

Comments and OCC Action

The OCC received 19 comment letters in response to the proposal. The commenters included eight trade associations, one professional association, six banks, two law firms, one private business, and one unaffiliated individual. The commenters generally supported the proposal but also recommended a number of specific modifications. Many of the commenters offered reasons why the OCC should remove or lessen structural limitations on investment in Type IV and Type V securities, particularly aspects of the proposed diversification requirements.

In the final rule, the OCC has addressed many of the concerns of the commenters and, in particular, has concluded that some of the proposal's definitional restrictions on Type IV and Type V securities are not necessary.

The final rule's structure is based on three core sections. Section 1.2 defines the five types of securities as well as other significant terms such as ''investment grade,'' ''investment security,'' and ''marketable.'' Section 1.3 prescribes limitations on dealing in, underwriting, purchasing, and selling each of the five types of securities defined in § 1.2, investment company shares, and securities held based on estimates of an obligor's performance. Section 1.3 prescribes special provisions on aggregation of securities with a common issuer and calculation of investment company holdings. Section 1.4 prescribes how a national bank must calculate the limits imposed by § 1.3.

The final rule also makes minor clarifying and technical changes. The following section-by-section analysis discusses the comments and substantive changes made by the final rule:

Authority, Purpose, and Scope (§ 1.1)

The proposal consolidated the former ''Scope and application'' section (§ 1.2) with the ''Authority'' section (§ 1.1). The proposal also clarified that the limitations set forth in part 1 apply to national banks, federal branches of foreign banks, District of Columbia banks, and state banks that are members of the Federal Reserve System.

The OCC received no comments on this section, which is adopted as proposed with minor clarifying changes.

Definitions (§ 1.2)

The proposal substantially revised the definitions section to add several new definitions and to update others. The proposal revised the definitions of Type I, II, and III securities to define the securities by their characteristics rather than by the statutory limitations on the extent to which national banks may deal in, underwrite, purchase, or sell them. The proposal also defined two new types of securities, Type IV and Type V securities, and added a definition of ''investment company.''

The final rule adds a new defined term, ''NRSRO.'' The final rule changes the paragraph letter designations for each definition accordingly. Of particular note, the final rule makes the following substantive changes:

Capital and Surplus (§ 1.2(a))

The proposal defined ''capital and surplus'' as the sum of Tier 1 and Tier 2 capital includable in risk-based capital under the Minimum Capital Ratios in 12 CFR part 3 appendix A, plus the balance of a bank's allowance for loan and lease losses that is not included in Tier 2 capital.

The OCC received three comments on this definition. The commenters noted that, because part 1 applies to state banks that are members of the Federal Reserve System, the OCC should adopt a definition of ''capital and surplus'' that applies the Board of Governors of the Federal Reserve System's (FRB's) definition of ''capital and surplus'' to state member banks. The OCC agrees with these commenters and has, therefore, changed the final rule to incorporate technical changes and to provide that banks must use the appropriate Federal banking agencies'' guidelines defining ''capital and surplus.''

Investment Grade (§ 1.2(d))

In many instances in the final rule, a security must be ''investment grade'' to be a permissible investment for a national bank. The proposal defined a security as ''investment grade'' when *each* nationally recognized statistical rating organization (NRSRO) that has rated the security has given it a rating in one of the top four rating categories. Thus, for purposes of this definition, if a security were given different ratings by different NRSROs, the lowest rating would govern. For example, if two NRSROs rated a security in one of their top four categories, but a third NRSRO did not give the security a top four rating (a so-called ''split- rated'' security), the security would not qualify as ''investment grade.''

The OCC received ten comments on this section. Seven commenters recommended that the OCC change the proposed definition to recognize a security as ''investment grade'' if only one NRSRO rates the security in one of the top four categories. These commenters asserted that otherwise any one NRSRO could render a particular security non-investment grade and, therefore, not permissible for a national bank to purchase. One commenter recommended that, at a minimum, the OCC should deem a security ''investment grade'' if a majority of the NRSROs that rate the security rate it in one of the top four categories.

The OCC agrees that giving a single NRSRO the ability to deem an investment impermissible for a national bank may be unnecessarily restrictive. Thus, the final rule defines the term ''investment grade'' to mean a security that receives a top four rating from either: (a) Two or more NRSROs; or (b) one NRSRO if the security has been rated by only one NRSRO. This approach assures that a security is sufficiently creditworthy while also allowing for some diversity in the evaluations produced by different NRSROs.

Some commenters requested that the OCC exclude unsolicited ratings from the definition. Under the proposal, an unsolicited non-investment grade rating would have rendered the security an impermissible investment for a national bank. However, the final rule recognizes unsolicited ratings, but no longer will permit a single unsolicited rating to render a security automatically ineligible for national bank investment.

Investment Security (§ 1.2(e))

The proposal defined ''investment security'' as a security that is: (1) An investment grade marketable debt obligation; or (2) the credit equivalent of an investment grade marketable debt obligation if the security is not rated. The OCC requested comment on whether to describe more specifically the characteristics of securities that are the credit equivalent of investment grade. The OCC also asked commenters to address whether other securities with characteristics functionally equivalent to a debt obligation might be classified as ''investment securities.''

The OCC received four comments on this section. The commenters generally supported the definition of ''investment security.'' Most commenters felt that defining ''credit equivalency'' by identifying specific characteristics would sacrifice flexibility.

The OCC agrees with the commenters and believes that to adopt specific identifiable characteristics of credit equivalency would unduly restrict flexibility in this area. Therefore, the OCC adopts the final rule as proposed.

Marketable (§ 1.2(f))

At § 1.5(a), the former rule defined a ''marketable'' security as one that may be sold with reasonable promptness at a price that corresponds reasonably to its fair value. The proposal replaced this definition with a more objective test that lists particular indicators of a ready market for a security. The proposal defined marketable as: (1) Securities registered under the Securities Act; (2) certain government securities exempt from Securities Act registration; (3) municipal revenue bonds exempt from Securities Act registration; and (4) securities that are investment grade and sold pursuant to Securities Exchange Commission (SEC) Rule 144A (17 CFR 230.144A), which exempts certain private resales of securities to institutional investors from Securities Act registration.

The OCC requested comment on whether the proposed definition of ''marketable'' is sufficiently inclusive, particularly regarding other exemptions under the Securities Act and whether the definition is appropriately inclusive of foreign sovereign debt. The OCC also asked commenters to suggest alternative definitions of marketable that would address the OCC's concerns about liquidity.

The OCC received 12 comments on this issue. A majority of the commenters recommended that the OCC expand the proposed definition or retain the former definition of marketable. These commenters asserted that the proposed definition was too restrictive and did not include certain securities that are included within the definition in the former regulation. For example, the commenters noted that foreign sovereign debt, bank and savings and loan debt securities (which are exempt from registration under the Securities Act), and commercial paper were not identified in the proposed definition even though they may have been included within the former marketability test.

The OCC did not intend to prescribe a marketability test that, through its objectivity, eliminates flexibility available under the former rule and unnecessarily excludes a broad range of securities. Therefore, the final rule retains the list of marketable securities contained in the proposal and adds to that list the definition of marketable contained in the former regulation, *i.e.*, a security that may be sold with reasonable promptness at a price that corresponds reasonably to its fair value. Thus, certain foreign sovereign debt and other securities may qualify under the revised definition of marketable. This approach also provides additional flexibility for the OCC to review the permissibility of national bank investment in particular securities on a case-by-case basis.

Several commenters also asked the OCC to remove the requirement that Securities Exchange Commission Rule 144A, 17 CFR 230.144A (Rule 144A) securities be rated investment grade in order to fall within the definition of ''marketable.'' These commenters stated that many privately-placed securities are not rated. One commenter advocated that the OCC should not adopt the proposal, because Rule 144A provides no assurance of marketability.

The OCC agrees that a Rule 144A security need not be rated investment grade to be marketable; but, if it is not rated investment grade, it must be the credit equivalent of investment grade. The final rule therefore does not adopt the proposed requirement that an NRSRO rate a Rule 144A security investment grade in order for the security to be marketable. Instead, consistent with other investment securities under this part, a Rule 144A security may qualify as investment grade, when not rated, and therefore qualify as marketable, if the bank determines that it is the credit equivalent of an investment grade security. The OCC expects that, as a matter of safe and sound banking practices, a bank will conduct a thorough analysis of a security's creditworthiness in order to satisfy itself that a particular security is the credit equivalent of investment grade.

The OCC has also determined that proposed § 1.2(f)(2) is unnecessary. That provision listed as one component of the definition of marketability each of the securities that is included in the definition of a Type I security. Because Type I securities are not required to satisfy a marketability test under section 24(Seventh), it is unnecessary for the rule to include these Type I securities in the definition of marketable. Therefore, the final rule is adopted without proposed § 1.2(f)(2). The remainder of paragraph § 1.2(f) is renumbered accordingly.

NRSRO (§ 1.2(g))

The OCC did not use the term ''NRSRO'' in the proposal. In making changes to the final rule's definition of, and limitations on, Type IV securities, the OCC found that referring to nationally recognized statistical rating organizations (NRSROs) was the most direct and clear means of drafting the rule. The final rule, therefore, adds ''NRSRO'' as a defined term.

The OCC has not listed the rating organizations that qualify as NRSROs in this definition. The OCC generally follows the assessment of the SEC in acknowledging the organizations that are currently NRSROs. The SEC recognizes NRSROs through no-action letters. The most recent SEC no action letter in which the SEC expressed no opposition to the recognition of an NRSRO is Thomson Bankwatch, Inc., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) paragraph 79,800 (August 6, 1991). *See* also 59 FR 46314 (September 7, 1994) (publishing an SEC ''Concept release'' on NRSROs).[3]

Several commenters suggested that the OCC recognize foreign rating organizations. The OCC finds that most significant foreign debt securities are rated by the NRSROs to which the SEC has expressed no objection and, at this time, sees no need to depart from the SEC's assessment of the rating organizations that are nationally recognized.

Type I Security (§ 1.2(i))

The proposal used language similar to that in the former rule to define ''Type I security'' to mean any one of specified government securities. The former rule and the proposal also incorporated key elements of an OCC interpretation regarding securities backed by the full faith and credit of the U.S. Government.

The OCC received four comments on this definition. Three commenters recommended that, consistent with 12 U.S.C. 24(Seventh), the OCC should add qualified Canadian government obligations to the definition of a Type I security. The OCC received one comment recommending that the OCC add the debt securities of certain developed foreign sovereigns to the list of Type I securities.

In accordance with 12 U.S.C. 24(Seventh), the final rule adds qualified Canadian government obligations to the list of Type I securities. The OCC acknowledges that, in the future, other securities may fulfill the definitional requirements of a Type I security, and the OCC will review securities, as appropriate, to determine if they meet the statutory requirements.

Type II Security (§ 1.2(j))

The proposal redefined a ''Type II security'' to mean an investment security that is issued by certain state, international, or multilateral organizations or that is otherwise listed or described in 12 U.S.C. 24(Seventh). In contrast, the former rule defined a Type II security by identifying the investment limits that apply to it and by listing examples of qualifying types of issuers.

The OCC received no comments on this definition, which is adopted as proposed. The OCC notes that the definition of Type II security also includes other securities that the OCC deems eligible as Type II securities in accordance with 12 U.S.C. 24(Seventh). This provision gives the OCC flexibility, consistent with the authorizing statute, to review securities that may fulfill the definitional requirements of a Type II security but are not listed in the definition.

Type III Security (§ 1.2(k))

The former rule defined a Type III security as a security that a bank may purchase and sell for its own account, subject to the 10 percent limitation in 12 U.S.C. 24(Seventh). The proposal redefined a Type III security as an investment security that does not qualify as a Type I, II, IV, or V security. The proposal listed corporate bonds and municipal revenue bonds as examples of Type III securities.

The OCC requested comment on whether to reference specifically other examples of Type III securities in addition to corporate bonds and municipal revenue bonds. In particular, the OCC requested comment on whether to include as Type III securities foreign securities that are eligible for investment by foreign branches of U.S. banks.

The OCC received seven comments on the definition of a Type III security. The majority of these commenters recommended that the OCC include in the list of examples that qualify as Type III securities foreign securities that are eligible for investment by foreign branches of national banks and mortgage backed securities (MBSs) that do not qualify as Type IV or Type V securities. One commenter also recommended that the OCC permit national banks to underwrite and deal in municipal revenue bonds.

The OCC has determined that the proposed definition of a Type III security provides appropriate examples of the scope of qualifying Type III securities. While certain mortgage backed securities and foreign securities eligible for investment by foreign branches of national banks will qualify as investment securities and are, therefore, Type III securities, others may not. The OCC has not concluded that all foreign securities eligible for investment by foreign branches of national banks qualify as a Type III investment security. Nor does the OCC want to imply that banks are precluded from purchasing other classes of securities,

[3] Currently, the NRSROs recognized by the SEC are: Duff and Phelps, Inc.; Fitch Investors Service, Inc.; IBCA Limited (and its subsidiary, IBCA Inc.); Moody's Investors Services Incorporated; Standard and Poor's Corporation; and Thomson Bankwatch, Inc.

which may meet the definition of ''investment security'' but are not specifically listed as a Type III security. This may be the case if, for example, the OCC were to add further to the list of examples, thereby appearing to create an exhaustive list of Type III securities. The OCC does not intend to create an exclusive list of Type III securities.

Type IV Security (§ 1.2(l))

The proposal added a new category of securities, Type IV securities, which SMMEA and CDRI made eligible for purchase by national banks in unlimited amounts. In 1984, the SMMEA amended 12 U.S.C. 24(Seventh) to permit national banks to purchase residential and commercial mortgage-related securities offered and sold pursuant to section 4(5) of the Securities Act of 1933 Act (Securities Act), 15 U.S.C. 77d(5), or residential mortgage-related securities as defined in section 3(a)(41) of the Exchange Act, 15 U.S.C. 78c(a)(41). The final rule incorporates the SMMEA amendments.

CDRI defined a new type of small business-related security in section 3(a)(53)(A) of the Exchange Act, 15 U.S.C. 78c(a)(53)(A), and added a class of commercial mortgage-related securities to section 3(a)(41) of the Exchange Act, 15 U.S.C. 78c(a)(41). CDRI's amendments to 12 U.S.C. 24(Seventh) removed limitations on purchases by national banks of certain small business-related and commercial mortgage-related securities. However, CDRI requires that certain residential and commercial mortgage-related securities must receive a rating from an NRSRO in one of the top *two* rating categories. Small business-related securities must receive a rating in one of the top *four* rating categories.

CDRI also authorized the OCC to prescribe regulations to ensure that acquisitions of statutorily defined residential and commercial mortgage-related securities and small business-related securities are conducted in a manner consistent with safe and sound banking practices. In its proposed definition of a Type IV security, the OCC sought to guard against undue concentration of risk that could arise were a bank to invest in a security backed by a small number of loans or if a small number of loans represents a large percentage of the assets in the pool. Therefore, the proposal required Type IV securities that are small business- or commercial mortgage-related securities to be fully secured by interests in a pool of homogeneous loans of numerous obligors.

To assure diversification, the proposal also provided that, for small business-related securities and commercial mortgage-related securities, the aggregate amount of collateral from loans of any one obligor could not exceed 5 percent of the total amount of the loans in the pool collateralizing the security (the ''5 percent collateral concentration limit'').

The OCC requested specific comment on whether to define the term ''homogeneous loans'' and whether the 5 percent collateral concentration limit was appropriate to assure adequate diversification of the collateral.

The OCC received 17 comments on the proposed definition of a Type IV security, particularly on the 5 percent collateral concentration limit and the homogeneity and numerous obligor requirements. Most commenters opposed the ''homogenous,'' ''numerous,'' and 5 percent collateral concentration restrictions, stating that they were impractical. Commenters opposing both the ''homogeneous'' and ''numerous obligor'' requirements asserted that those terms are vague and difficult to apply because they are not defined. In particular, the commenters asserted that the homogeneity requirement conflicts with the diversification objective of pooling commercial loans. These commenters stated that commercial loans, by their nature, are seldom homogeneous.

Most commenters also recommended that the OCC eliminate the 5 percent collateral concentration limit on loans of any one obligor in Type IV security loan pools. The commenters emphasized that the plain language of CDRI permits unlimited investment in commercial mortgage-related and small business-related securities. These commenters asserted that NRSROs consider concentration risk when they rate a particular security, thereby making the 5 percent collateral concentration limit unnecessary. They also asserted that the limit fails to consider compensating factors such as credit enhancements, stable cash flow, prime location of mortgage properties, construction quality of mortgaged property, and barriers to competition, which are all considered by rating agencies.

The commenters also cited the following reasons for their opposition to the 5 percent collateral concentration limit: (1) The 5 percent collateral concentration limit mistakenly focuses solely on the obligor, does not focus on the collateral for the security, and therefore fails to ensure diversification of collateral. A collateral pool that satisfies the 5 percent collateral concentration limit will not necessarily contain diverse collateral; however, a single borrower/obligor can produce a commercial mortgage-backed security pool that has diverse collateral. (2) The majority of commercial mortgage loans are nonrecourse to the borrower and, therefore, borrower diversity is less relevant than tenant creditworthiness. (3) The 5 percent collateral concentration limit will be unnecessarily burdensome and costly relative to any benefits it provides because it will require a transaction-by-transaction analysis and the production and maintenance of voluminous reports regarding the make-up of each commercial mortgage-related security pool.

Some commenters recommended raising the 5 percent collateral concentration limit to a 20 percent limit. One commenter recommended that the OCC use existing authority to assess a risk-based capital surcharge when holdings of a Type IV security exceed the aggregate amount of the appropriate percentage of capital and surplus.

The OCC agrees with many of the reasons cited by the commenters and has not adopted the homogeneity and 5 percent collateral concentration limit. In particular, the OCC believes that the statutory requirements for residential and commercial mortgage-related securities defined in 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41), to have an NRSRO rating in one of the top two categories and for small business-related securities to receive a rating in one of the top four rating categories provide sufficient safeguards against investment risks. NRSRO ratings reduce the risk of investment posed to banks because of the NRSROs' resources and ability to analyze such factors as cash flow treatments, credit facilities, *and* collateral diversification. To ensure that banks do not purchase, in unlimited amounts, commercial and residential mortgage-related securities that are offered or sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5), that are predominantly speculative in nature, the final rule requires that these securities at least be investment grade.

In addition, the final *retains* the requirement that the securities be composed of interests in a pool of loans to ''numerous'' obligors. The OCC believes that this requirement reflects an essential diversified risk characteristic of a mortgage-related or small business-related security and does not unduly limit a national bank's ability to invest in these asset-backed securities.

Type V Security (§ 1.2(m))

The proposal created a new category of securities, Type V, that are *investment grade* securities composed of loans in which a bank may invest directly. This definition reflected the OCC's long-standing interpretations that, in addition to the investments described in 12 U.S.C. 24(Seventh), a national bank may hold securitized forms of assets in which it may invest directly.[4]

Under the proposal, the definition of a Type V security included the same limitations that were included in the definition of a Type IV security (*i.e.*, ''homogeneous loans'' from ''numerous obligors'' with the obligations of any one obligor composing no more than 5 percent of the pool). In order to assure the high quality of this type of asset-backed security, the proposal also required that a Type V security be rated investment grade.

The commenters recommended that the OCC eliminate these requirements, citing many of the same reasons stated in their comments on the definition of a Type IV security. For the same reasons discussed in relation to Type IV securities previously, the OCC agrees with the commenters. Thus, the final rule does not include the proposed ''homogeneity'' and 5 percent collateral concentration limits but does *retain* the requirement that the securities be composed of a pool of loans to ''numerous'' obligors.

In addition, in order to ensure safe and sound investment in these securities, the final rule requires a Type V security to be ''marketable'' as defined in § 1.2(f). The marketability requirement is in addition to the investment grade requirement for a Type V security and further ensures that national banks do not acquire asset-backed securities that have speculative characteristics.

Limitations on Dealing in, Underwriting, and Purchasing and Selling Securities (§ 1.3)

The proposal consolidated the part 1 provisions that limit dealing in, underwriting, purchasing, and selling different types of securities. The proposal limited ''the aggregate par value of the obligations of any one obligor'' of a Type II, III, or V security that a bank may hold to a specific percentage limit. For example, the proposal restricted the aggregate par value of the obligations of any one Type II obligor held by the bank to no more than 10 percent of the bank's capital and surplus. The proposal also imposed a 10 percent limit on Type III securities and a 15 percent limit on Type V securities.

The OCC requested specific comment on whether using the aggregate par value of obligations of any one obligor is an appropriate measure of value.

Four commenters recommended that the OCC replace ''par value'' with ''market value,'' asserting that par value does not account for obligations acquired either at a discount or premium.

The OCC has determined, however, that par value is the practical and objective gauge by which to measure value in this context, and the final rule therefore uses par value.

Some commenters also recommended that the OCC permit banks to use a netting approach in calculating limitations by which a bank could reduce its ownership exposure (long position) in a security by taking a short position in that same security. The commenters suggested that the OCC authorize banks to net their long and short positions in a security because the investment limitations in part 1 apply not only to amounts held by a bank but also to obligations that a bank is ''legally committed to purchase and sell.'' These commenters assert that banks should be able to exclude from their investment limit calculations any securities for which there is both a commitment by a bank to sell and by a third party to buy.

The OCC agrees that a netting of long and short position in a particular security may be appropriate for purposes of calculations under part 1, and the language of the final rule, noted above, will accommodate this approach. However, the OCC's responses on this issue are likely to be more detailed than is appropriate for a regulation, and will be based on the transaction at issue. Therefore, specific issues on this point will be addressed by the OCC on a case-by-case basis.

The final rule also makes several minor clarifying changes to § 1.3.

Type II and III Securities; Other Investment Securities Limitations (§ 1.3(d))

The proposal provided that a national bank may not hold Type II and Type III securities of any one obligor that have a combined aggregate par value exceeding 10 percent of the bank's capital and surplus. However, the proposal did not require aggregation with respect to industrial development bonds. Instead, the proposal applied the 10 percent limitation separately to each security issue of a single obligor when the proceeds of that issuance are to be used to acquire and lease real estate and related facilities to economically and legally separate industrial tenants, and the issuance is payable solely from and secured by a first lien on the revenues to be derived from rentals paid by the lessee under net noncancellable leases.

The OCC received no comments on this section, which is adopted as proposed.

Type IV Securities (§ 1.3(e))

The proposal provided that national banks could purchase, without limitation, securities that meet the definition of a Type IV security. This proposal relied on the authority granted to national banks by SMMEA and CDRI to purchase and sell certain mortgage- and small business-related securities in unlimited amounts.

The proposal also incorporated OCC interpretations concerning the authority of a national bank to deal in obligations that are fully secured by Type I securities.[5] These interpretations reflect the OCC's consistent approach of looking to the underlying substance of an instrument to determine whether a bank may deal in, underwrite, purchase, or sell the instrument. In the case of a Type IV security that is fully secured by Type I securities, the ultimate source of repayment is Type I securities. The proposal did not limit the categories of Type IV securities in which banks may deal, if the securities are fully collateralized by Type I securities. Thus, under the proposal, a bank's authority to deal in these securities would be determined with reference to the standards that apply to Type I securities. (The ability of a bank to

[4] *Securities Industry Ass'n v. Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990) (national bank authority to securitize assets); Interpretive Letter No. 540 (December 12, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,252 (securitized credit card receivables); Interpretive Letter No. 514 (May 5, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,218 (securitized mortgages); Investment Securities Letter No. 29 (August 3, 1988), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,899 (investment limits for asset-backed securities consisting of GMAC receivables); Interpretive Letter No. 416 (February 16, 1988), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,640 (securitized automobile loans); No Objection Letter No. 87–9 (December 16, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,038 (securitization of commercial loans originated by the bank); Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612 (mortgage-backed pass-through certificates); Interpretive Letter No. 362 (May 22, 1986), *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,532 (bonds collateralized by mortgages).

[5] *See* Interpretive Letter No. 514 (May 5, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,218; Interpretive Letter No. 362 (May 22, 1986), *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,532.

securitize and sell loans and other obligations it holds, including loans that qualify as collateral for Type IV securities, is addressed in § 1.3(g).)

Congress made clear that it intended the OCC and other bank regulatory agencies to have authority to limit or restrict bank purchases of securities in order to ensure the safety and soundness of insured depository institutions. See H.R. Conf. Rep. No. 652, 103rd Cong., 2nd Sess. sec. 347, at 184 (1994). The OCC believes that it can ensure safe and sound investments involving purchases of small business-related securities, as defined in section 3(a)(53)(A) of the Exchange Act, 15 U.S.C. 78c(a)(53)(A), if the OCC permits purchases in unlimited amounts only if the small business-related securities are rated in one of the top two rating categories by an NRSRO. In addition, however, the final rule permits a national bank to purchase small business-related securities that an NRSRO has rated in the top third or fourth rating category, provided the bank may not hold small business-related securities from a single issuer if the aggregate par value of the security exceeds 25 percent of the bank's capital and surplus. The OCC has imposed this 25 percent limit as a safety and soundness-based prudential limit.

Type V Securities (§ 1.3(f))

The proposal limited a national bank's holding of Type V securities from any one obligor (or certain related issuers) to 15 percent of the bank's capital and surplus. The OCC requested specific comment on whether a higher limit, such as 25 percent, would be sufficient to prevent excess concentration.

Four commenters questioned whether the OCC intended the term ''obligor,'' in this context, to mean the underlying borrowers whose notes comprise a security. The OCC did not intend that result. The 15 percent limit applied to the entity that was issuer of the security, not to each obligor on the loans that back a particular security. The final rule clarifies this point by substituting the word ''issuer'' for ''obligor.''

One of these commenters noted that the OCC used the terms obligor and issuer interchangeably in other sections of the rule and recommended that the OCC clarify the terms. To address this concern, the text of the final rule has been revised to use the two terms in a more precise fashion and rephrase certain sections to enhance clarity.

Many commenters recommended that the OCC raise the capital limitation for Type V securities from 15 percent to 25 percent. These commenters asserted that Type V securities are analogous to secured loans and therefore should be eligible for the 25 percent limit of 12 U.S.C. 84.

The OCC has carefully considered these comments, and the final rule replaces the proposed 15 percent limitation with a 25 percent of capital limitation. The OCC believes the 25 percent of capital limit is a prudential limit that provides sufficient protection against undue risk concentrations. This limit parallels the 25 percent credit concentration benchmark in the Comptroller's Handbook for National Bank Examiners. The Handbook identifies credit concentrations in excess of 25 percent of a bank's capital as raising potential safety and soundness concerns. For this purpose, the Handbook guidance aggregates direct and indirect obligations of an obligor or issuer and also specifically contemplates application of the 25 percent benchmark to concentrations that may result from an acquisition of a volume of loans from a *single source*, regardless of the diversity of the individual borrowers. *See* Comptroller's Handbook § 215. Accordingly, national banks are urged to monitor carefully their aggregate credit exposure to any single obligor or issuer in order to avoid imprudent concentrations of credit.

This provision is otherwise adopted as proposed.

Securitization (§ 1.3(g))

The proposal added this section to incorporate the OCC's long-standing position that a national bank may securitize and sell loan assets that it holds. The ability of a bank to sell loans and other obligations through the issuance and sale of certificates evidencing interests in pools of the assets provides flexibility that can enhance bank safety and soundness.[6] The provision is adopted substantially as proposed and reflects the OCC's long-standing treatment of national banks' securitization activities as affirmed by case law.[7] National banks engaging in securitization activities should consult OCC Bulletin 96–52 (September 25, 1996), which provides guidelines for national banks on their securitization activities.

Investment Company Shares (§ 1.3(h))

The proposal incorporated OCC interpretations concerning the authority of a national bank to hold instruments representing indirect interests in assets in which the bank could invest directly.[8] Former part 1 did not address a national bank's investment in an investment company. The proposal permitted a national bank to purchase and sell for its own account shares of a

[6] *See, e.g.*, Remarks by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System before the American Bankers Association (October 8, 1994). *See also* Statement by Donald G. Coonley, Chief National Bank Examiner, OCC, *Asset Securitization and Secondary Markets: Hearings Before the Subcomm. on Policy, Research, and Insurance of the Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess. 2–4 (1991), *reprinted in OCC Quarterly Journal* (December 1991); and Joint Statement by Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, and Donald H. Wilson, Financial Markets Officer, Federal Reserve Bank of Chicago, *Secondary Market for Commercial Real Estate Loans: Hearings Before the Subcomm. on Policy, Research, and Insurance of the Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 2d Sess. 16–19 (1992), *reprinted in* 78 *Fed. Res. Bull.* 492 (1992).

[7] *See, e.g.*, Interpretive Letter No. 585 (June 8, 1992), *reprinted in* [1992–1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,406 (securitized motor vehicle retail installment sales contracts purchased from automobile dealers); Interpretive Letter No. 540 (December 12, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,252 (securitized credit card receivables originated by bank or purchased from others); Interpretive Letter No. 514 (May 5, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,218 (securitized mortgages); Interpretive Letter No. 416 (February 16, 1988), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,640 (securitized automobile loans); Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612 (sale of mortgage-backed pass-through certificates); No Objection Letter No. 87–9 (December 16, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,038 (securitization of commercial loans originated by the bank); Interpretive Letter No. 362 (May 22, 1986), *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,532 (sales of bonds collateralized by mortgages). Regarding sales of participations in pools of loans, *see* Letter from Billy C. Wood, Deputy Comptroller, Multinational Banking (May 29, 1981), *reprinted in* [1981–82 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,275; Letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision (February 1, 1980), *reprinted in* [1981–82 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,213; Letter from John M. Miller, Deputy Chief Counsel (July 31, 1979), *reprinted in* [1978–79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,182; Letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision (April 20, 1979), *reprinted in* [1978–79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,167; Letter from H. Joe Selby, Deputy Comptroller for Operations (October 17, 1978), *reprinted in* [1978–79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,144; Letter from John G. Heimann, Comptroller of the Currency (May 18, 1978), *reprinted in* [1978–79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,116; Letter from Charles B. Hall, Deputy Comptroller for Banking Operations (February 14, 1978), *reprinted in* [1978–79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,100; Letter from Robert Bloom, Acting Comptroller of the Currency (March 30, 1977), *reprinted in* [1973–78 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 97,093. Regarding national bank authority to securitize assets, *see Security Pacific* v. *Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990).

[8] Banking Circular 220 (November 21, 1986); An Examiner's Guide to Investment Products and Practices at 23 (December 1992).

registered investment company, subject to two requirements: First, the investment company's portfolio must be composed entirely of assets in which the bank could invest directly. Second, the amount of the bank's investment in shares of any one investment company is subject to the most stringent investment limitations applicable to the underlying securities and loans that compose that investment company's portfolio.

The proposal permitted banks to purchase shares in investment companies, including mutual funds, that are registered under section 8 of the Investment Company Act of 1940 ('40 Act), 15 U.S.C. 80a-8. *See* § 1.2(c) (defining ''investment company''). The OCC requested comment on whether the OCC should permit banks to purchase shares of limited partnerships with fewer than 100 investors, *i.e.*, a partnership that would not qualify as an investment company within the meaning of section 3(c)(1) of the '40 Act, if the partnerships' portfolios consist solely of Type I securities that the bank may purchase and sell for its own account. The '40 Act's definition of ''investment company'' excludes issuers whose outstanding securities are beneficially owned by 100 or fewer persons and who are not making, or do not presently propose to make, a public offering of their securities.

Several commenters recommended that the OCC permit banks to purchase shares in entities with 100 or fewer investors, although these entities would not be subject to '40 Act regulation. The commenters asserted that so long as the pass-through entity allows a bank to invest solely in investments that the bank could purchase directly for its own account, the number of investors should not matter.

One commenter opposed expanding the proposed definition asserting that the '40 Act establishes a regulatory framework for investment companies that addresses the unique risks posed by pooled investment vehicles. The commenter asserted that to allow national banks to invest in entities not subject to the '40 Act, for their own accounts, could leave bank capital open to substantial risk.

The OCC agrees with this commenter that the absence of a regulatory scheme, such as the '40 Act, could pose additional risk for national banks. Therefore, the final rule adopts the definition of ''investment company'' as proposed in § 1.2(c). Further, the final rule does not expressly permit banks to purchase shares from entities with 100 or fewer investors that are exempt from '40 Act registration.

However, the OCC recognizes that there may be circumstances in which a bank's purchase of interests in a certain exempt investment fund would be acceptable. Therefore, the final rule provides that, on a case-by-case basis, the OCC may determine that interests in other entities, the portfolios of which consist exclusively of investments eligible for national banks to hold directly, also are permissible for national banks.

The final rule also relocates the provision that limited the amount of the bank's investment in shares of any one investment company to the most stringent investment limitations applicable to the underlying securities that compose that investment company's portfolio. The OCC has determined that, for clarity, this limitation belongs in § 1.4, which governs the calculation of limits. As discussed later, the final rule also changes this limitation.

Securities Held Based on Estimates of Obligor's Performance (§ 1.3(i))

The proposal retained the flexibility contained in the former rule that permitted a bank, notwithstanding the general definition of an investment security in § 1.2(e), to treat certain debt securities, (such as pools of mortgage or business loans in moderate and low-income areas or community development loans), as investment securities when the bank concludes, on the basis of estimates that the bank reasonably believes are reliable, that the obligor will be able to meet its obligations under that security.

The OCC requested comment on whether it should provide further clarification of the standards applicable to securities held based on estimates of obligor's performance and, if so, what clarification is needed.

The majority of the commenters on this section asserted that it would not be helpful for the OCC to provide further clarification of the standards applicable to securities held based on estimates of an obligor's performance. Therefore, the OCC adopts the final rule as proposed.

Calculation of Limits (§ 1.4)

The proposal added a section that consolidated the calculation of limits requirements of part 1.

Proposed paragraphs (a) and (b) § 1.4 prescribed the dates for calculating capital and surplus and stated the OCC's authority to require more frequent calculations. The proposal required a bank to calculate its investment limitations as of the most recent of: (1) The date on which the bank's Consolidated Report of Condition and Income (call report) is properly signed and submitted; (2) the date on which the bank's call report is required to be submitted; or (3) the date on which there is a change in the bank's capital category for purposes of 12 U.S.C. 1831o and 12 CFR 6.3.

The OCC received no significant comments on these paragraphs. The final rule makes the following changes to the proposal to conform to the OCC's recently proposed changes to its lending limit regulation, 12 CFR part 32. *See* 61 FR 37227 (July 17, 1996). The final rule requires a bank to determine its investment limitations as of the most recent of: (1) The last day of the preceding calendar quarter; or (2) the date on which there is a change in the bank's capital category for purposes of 12 U.S.C. 1831o and 12 CFR 6.3.

The final rule prescribes an effective date for a bank's investment limit. The final rule provides that an investment limit that is calculated as of the last day of the preceding calendar quarter becomes effective on the earlier of the date on which the bank's call report is submitted or the date on which the bank's call report is required to be submitted. An investment limit calculated as of the date on which there is a change in the bank's capital category becomes effective on that day.

The effective date requirements are added in a new paragraph § 1.4(b). The final rule moves proposed paragraph § 1.4(b), which stated the OCC's authority to require more frequent calculations, to § 1.4(c), to accommodate the insertion of new paragraph § 1.4(b) and otherwise adopts that paragraph § 1.4(c) as it was proposed.

Calculation of Type III and Type V Securities Holdings (§ 1.4(d))

Proposed § 1.4(c) limited a national bank's holdings of Type III investment securities of any one issuer/obligor (or certain related issuer/obligors) to 10 percent of the bank's capital and surplus. The proposal limited a national bank's holdings of Type V securities of any one issuer/obligor to 15 percent of the bank's capital and surplus. In calculating these capital limits, the proposal required a bank to combine: (1) Obligations of issuer/obligors that are related directly or indirectly through common control; and (2) securities of issuer/obligors that are credit-enhanced by the same entity.

The OCC requested comment on other bases upon which a bank should combine its holdings when calculating its investment in Type III or Type V securities of any one issuer/obligor. Specifically, the OCC asked whether a bank should combine obligations that are predominately collateralized by loans made by the same originator or by originators that are related directly or indirectly through common control. In addition, commenters were asked to address whether and under what circumstances an issuer or affiliate of the issuer would provide a guarantee or other form of credit enhancement for Type V securities that could be a source of credit exposure of the investing bank to the issuer or its affiliate. Comment was also invited on whether the 15 percent investment limitation or a lower limitation is appropriate under these circumstances.

Five commenters stated that the OCC should not require banks to combine obligations of issuer/obligors of Type V securities that are related through common control. These commenters asserted that the risk assessment for the securities is based on the creditworthiness of the underlying *borrowers* whose loans collateralize the issuance, and on the credit enhancement rather than on the creditworthiness of the Type V issuer/obligor. They stated that, if the parent company provides no guarantee, there is no common source of risk and that applying a limitation on common sources of credit enhancement is sufficient to safeguard against risk concentrations. Similarly, a few commenters also recommended that the OCC remove the requirement to aggregate holdings of entities under direct or indirect common control for Type III securities. They asserted that the requirement would be unduly burdensome for banks.

The OCC continues to believe that combining obligations of issuer/obligors that are related through common control represents a prudent supervisory response, given the effect of common control on underwriting standards and servicing effectiveness, and especially in light of other burden reducing changes the OCC has made to the final rule. Thus, the final rule retains the requirement that banks aggregate issuer/obligors of Type III and Type V securities, respectively, that are under common ownership or control.

The comments demonstrate that the proposal left unclear whether it required banks to aggregate Type III and Type V securities issued by the same issuer/obligor. The final rule adds a new provision to clarify that the aggregation requirement applies separately to Type III and Type V securities. The OCC emphasizes, however, that the Comptroller's Handbook for National Bank Examiners identifies credit concentrations in excess of 25 percent of a bank's capital as raising potential safety and soundness concerns. For this purpose, the Handbook guidance does aggregate direct and indirect obligations of an issuer/obligor. Thus, if a bank's aggregate holdings of Type III and Type V securities issued by the same issuer/obligor exceed 25 percent of the bank's capital, the bank, as a matter of safety and soundness, should have carefully considered whether, and be able to demonstrate why, the characteristics of the Type III and Type V securities it holds do not entail an undue concentration.[9]

As noted in the earlier discussion of § 1.3(f), the final rule changes the Type V limitation from 15 percent to 25 percent of capital and surplus. The final rule also changes proposed paragraph § 1.3(c) to paragraph § 1.3(d) to accommodate the insertion of new paragraph § 1.3(b).

Calculation of Investment Company Holdings (§ 1.4(e))

In § 1.4(d), the proposal required a bank to use reasonable efforts to calculate and combine its pro rata share of a particular security in the portfolio of each investment company with the bank's direct holdings of securities of that issuer. In § 1.3(h), the proposal required the bank to apply the most stringent investment limit that would apply to the underlying securities in the investment company's portfolio.

For example, if the investment company holds a Type III security, the proposal limited the bank's holdings of shares of that investment company to 10 percent of the bank's capital and surplus. The proposal would thereby have codified Banking Circular 220 (BC 220) (Nov. 21, 1986), which authorizes national banks to purchase the shares of investment companies whose portfolios are comprised entirely of bank-eligible securities.

One commenter asserted that application of the most restrictive limit at the investment company level unnecessarily constrains a national bank's ability to buy investment company shares, especially when the company's portfolio contains only a proportionately small amount of securities subject to an investment limit. As the commenter noted, the treatment prescribed by the proposal would restrict the bank's purchase of the shares of the hypothetical mutual fund described above to 10 percent of capital and surplus even if the fund's portfolio was not evenly divided between Type I and Type III securities but contained 95 percent Type I and 5 percent Type III securities.

The commenter recommended that the OCC permit banks to use a ''pass-through'' analysis instead, that is, that the OCC permit banks to disregard the investment company level for purposes of applying the investment limits and allow banks to apply the applicable limit only to the pro rata portion of the underlying securities. This commenter also noted that allowing pass-through treatment is more consistent with the requirement in proposed § 1.4(d), by which banks must make ''reasonable efforts'' to aggregate their direct and indirect holdings of a security.

The final rule consolidates the two investment limit requirements set forth in §§ 1.3(h) and 1.4(d) into a single investment limit calculation provision, paragraph § 1.4(e). The final rule also modifies these provisions significantly in consideration of the comment received.

The OCC agrees that the OCC should give banks the flexibility to apply a pass-through analysis to determine the applicable investment limit if the bank aggregates its pro rata holdings of a security in an investment company with the bank's direct and other indirect holdings of that security. Therefore, the final rule permits banks to look through to the securities in the portfolio of an investment company and apply the appropriate limitation to the aggregate of the bank's pro rata interest in securities of a particular issuer that are held in an investment company's portfolio and the bank's direct holdings of the same securities.

The OCC recognizes that some institutions may prefer the method set forth in proposed § 1.3(h), which implemented BC 220 and required banks to apply the most stringent applicable investment limit to the bank's entire holdings of a particular investment company. Because calculating *pro rata* holdings of securities that the bank holds through an investment company may be burdensome for some institutions, the final rule gives a bank the option to apply the most stringent investment limit to the bank's entire holdings of a

[9] Similarly, a bank may acquire debt obligations of an issuer/obligor pursuant to the bank's authority to make loans, (provided appropriate underwriting standards are met) rather than under its authority to hold investment securities. *See* OCC Interpretive Letter No. 663, *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,611 (June 8, 1995); OCC Interpretive Letter No. 600, *reprinted in* [1992–1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,427 (July 31, 1992); OCC Banking Circular 181 (Rev) (Purchase of loans in whole or in part-participations) (August 2, 1984). In such a case, the holding would be permissible under a separate authority of the bank, but the credit concentration standards described in the Comptroller's Handbook would still be applicable and could curtail the amount of the bank's holdings under the two different sources of authority.

particular investment company if the investment company is diversified. An investment company is diversified if its holdings of the securities of any one issuer do not exceed 5 percent of the investment company's total portfolio.

For institutions that choose to calculate an investment limit using the most stringent applicable limit, the final rule does not require a bank to aggregate the investment company's holdings of a security with the bank's direct holdings of the security. The OCC believes that the 5 percent diversification requirement applicable to diversified investment companies provides sufficient protection against risk concentrations when a bank elects to apply the most stringent investment limit to the bank's investment in the investment company.

Safe and Sound Banking Practices; Credit Information Required (§ 1.5)

The proposal changed the requirement that, in addition to the specific requirements of part 1, a bank must exercise ''prudent banking judgment'' to a requirement that a bank must adhere to ''safe and sound banking practices,'' and identified certain risks that a bank should consider as part of safe and sound banking. The proposal also required each bank to obtain credit information that demonstrates the ability of issuer/obligors to satisfy their obligations and to maintain records that document the bank's compliance with this section.

The OCC received no comments on this section. The proposal required banks to consider market, interest rate, liquidity, legal, and operations and systems risks, as well as credit risk. The final rule conforms the list of risks identified by the proposal to the risks that are now specified in the OCC's risk-based supervision approach. The final rule requires banks to consider interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risks. The final rule also makes minor stylistic changes to this section.

Convertible Securities (§ 1.6)

The proposal set forth the restrictions on investment in certain convertible securities. The proposal required a bank to write down the carrying value of a convertible security to an amount that represents the value of the security considered independently of the conversion feature or attached stock purchase warrant. The proposal also prohibited a bank from purchasing securities convertible into stock at the option of the issuer.

The OCC received no comments on this section. However, the OCC has determined that requiring a bank to write down the carrying value of a security independently of the conversion feature is not consistent with generally accepted accounting principles (GAAP). Therefore, the final rule eliminates this requirement. While the final rule does not specifically state that a bank must account for convertible securities in accordance with GAAP, it is the OCC's policy that if the OCC is silent on accounting treatment, the OCC requires banks to conform with GAAP.

The final rule adopts as proposed the provision prohibiting national banks from purchasing securities convertible into stock at the option of the issuer.

Securities Held in Satisfaction of Debts Previously Contracted; Holding Period; Disposal; Accounting Treatment; Non-Speculative Purpose (§ 1.7)

The proposal added new provisions to clarify how a bank must treat securities held in satisfaction of debts previously contracted (DPC). These provisions embodied standards prescribed in the OCC's regulation on other real estate owned (OREO), 12 CFR part 34, and the OCC's related interpretation, *see* Interpretive Letter No. 604 (October 8, 1992). The proposal provided that a national bank holding securities in satisfaction of DPC may do so for a period of five years from the date that ownership of the securities was originally transferred to the bank, plus, if permitted by the OCC, an additional five years. The proposal also required a bank to mark-to-market securities held in satisfaction of DPC.

The OCC received one comment on this section. The commenter suggested that the OCC should avoid specifying an accounting treatment in the rule. Instead, the commenter recommended that a reference be made to the call report instructions.

The OCC agrees that it is unnecessary to specify the accounting treatment for DPC securities in the regulation. Accordingly, the final rule removes the reference to mark-to-market accounting and simply says that banks should account for DPC securities consistent with GAAP. In addition, the OCC emphasizes that extensions of the five-year holding period for shares acquired DPC are not automatic. While the five year holding period, plus extensions up to an additional five years, is based on the OCC's OREO standards, the OCC expects that a bank should, in general, be able to dispose of DPC securities more quickly than real estate. Accordingly, the OCC will require a clearly convincing demonstration of why any additional holding period is needed for securities acquired DPC.

Nonconforming Investments (§ 1.8)

The proposal clarified that a bank does not violate an applicable investment limitation when an investment in securities that was legal when made becomes nonconforming as a result of certain enumerated events, if the bank exercises reasonable efforts to bring the investment into conformity with applicable limitations.

The OCC asked commenters to address whether: (1) the phrase ''reasonable efforts'' needs additional clarification; (2) the OCC should require a bank to make ''reasonable efforts'' to bring into conformity an investment where the quality of a security deteriorates so that the security is no longer an investment security; and (3) any other events should be added to the list of circumstances that may cause an investment in securities to become nonconforming.

Two commenters recommended that the OCC eliminate the requirement that a bank must make reasonable efforts to conform an asset to the appropriate investment limit. The commenters stated that the requirement should not apply because the factor that caused nonconformity is beyond the bank's ability to control. One commenter noted that the reasonable efforts language might require a bank to sell securities at an exaggerated loss. Similarly, two commenters asked the OCC to clarify that a bank will have a substantial period of time before it is required to sell a non-conforming investment if the sale would result in a loss to the bank.

The OCC does not intend ''reasonable efforts'' to mean that a bank should sell a nonconforming investment at an exaggerated or unnecessary loss. The OCC intends a bank to use sound banking judgment to determine when it would be inappropriate to sell or reduce its holdings of a nonconforming investment. In the final rule, the OCC adopts the requirement that a bank must use reasonable efforts to bring an investment into conformity with the understanding that ''reasonable efforts'' should not pose significant harm to the bank if a reasonable probability exists that a loss can be avoided in the foreseeable future. The final rule makes minor clarifying changes to this section.

Amortization of Premiums (Former § 1.10)

The proposal removed former § 1.10 because the OCC believes that GAAP appropriately governs the treatment of premiums. GAAP requires that a bank defer recognition of a premium paid for an investment security and amortize the premium over the period to maturity of the security. In contrast, former § 1.10 permitted a bank to charge off the entire premium at the time of purchase or to amortize the premium in any manner the bank considers appropriate as long as the premium is extinguished entirely at or before the maturity of the security.

The OCC received no comments on the removal of this section, which is therefore removed in the final rule.

Interpretations

Indirect General Obligations (§ 1.100)

The proposal clarified and shortened former § 1.120 and renumbered it § 1.100. The proposal removed former paragraphs (f) ''Tax anticipation notes,'' and (g) ''Bond anticipation notes'' as unnecessary.

The OCC received no significant comments on this section, which is adopted as proposed.

Eligibility of Securities for Purchase, Dealing in, and Underwriting by National Banks; General Guidelines (Former § 1.100)

The proposal removed former § 1.100, which contained introductory and explanatory comments that the OCC believes are unnecessary in light of other proposed changes to part 1.

The OCC received no comments on the proposal's removal of this section.

Taxing Powers of a State or a Political Subdivision (§ 1.110)

The proposal shortened former § 1.130, removed portions that are no longer necessary, and renumbered it § 1.110. The proposal added new text to provide standards for determining when obligations that are expressly or implicitly dependent upon voter or legislative authorization of appropriations are considered supported by the full faith and credit of a State or political subdivision.

The OCC received no significant comments on this section, which is adopted as proposed.

Prerefunded or Escrowed Bonds and Obligations Secured by Type I Securities (§ 1.120)

The proposal made former § 1.120(e) proposed § 1.120. The OCC proposed no substantive changes to this provision.

The OCC received no comments on this section, which is adopted as proposed.

Type II Securities; Guidelines for Obligations Issued for University and Housing Purposes (§ 1.130)

The proposal streamlined former § 1.140, clarified the types of issuers whose obligations qualify as Type II securities, and renumbered the section § 1.130.

The OCC received no comments on this section, which is adopted as proposed.

Effective Date

The final rule takes effect on December 31, 1996. The OCC finds good cause for prescribing this year-end effective date in that it will enable national banks to adjust their practices to conform with the regulation at the beginning of a calendar quarter, which also marks the beginning of a reporting period for purposes of the Consolidated Report of Condition and Income (Call Report). 5 U.S.C. 553(d)(3).

DERIVATION TABLE

[Only substantive modifications, additions and changes are indicated]

Revised provision	Original provision	Comments
§ 1.1	§§ 1.1, 1.2	Modified.
§ 1.2(a)		Added.
§ 1.2(b)	§ 1.3(g)	Modified.
§ 1.2(c)	—	Added.
§ 1.2(d)	—	Added.
§ 1.2(e)	§ 1.3(b)	Modified.
§ 1.2(f)	§ 1.5(a)	Significant change.
§ 1.2(g)	—	Added.
§ 1.2(h)	§ 1.3(f)	
§ 1.2(i)	§§ 1.3(c), 1.110	Modified.
§ 1.2(j)	§ 1.3(d)	Modified.
§ 1.2(k)	§ 1.3(e)	Modified.
§ 1.2(l)	—	Added.
§ 1.2(m)	—	Added.
	§ 1.3(a)	Removed.
§ 1.3(a)	§ 1.4	Modified.
§ 1.3(b)	§§ 1.3(d), 1.6, 1.7(a)	Modified.
§ 1.3(c)	§§ 1.3(e), 1.7(a)	Modified.
§ 1.3(d)	§ 1.7(a), 12 CFR 7.1021	Modified.
§ 1.3(e)	—	Added.
§ 1.3(f)	—	Added.
§ 1.3(g)	—	Added.
§ 1.3(h)	—	Added.
§ 1.3(i)	§§ 1.5(b), 1.7(b)	Modified.
§ 1.4	—	Added.
§ 1.5	§ 1.8	Significant change.
§ 1.6	§ 1.9	Modified.
§ 1.7(a)	§ 1.11	
§ 1.7(b)	—	Added.
	§ 1.7(c)	Removed.
	§ 1.7(d)	Added.
§ 1.7(c)	—	Added.
§ 1.8	—	Added.
	§ 1.10	Removed.
	§ 1.100	Removed.
§ 1.100(a)	§ 1.120	

DERIVATION TABLE—Continued

[Only substantive modifications, additions and changes are indicated]

Revised provision	Original provision	Comments
§ 1.100(b)(1)	§ 1.120(a)	
§ 1.100(b)(2)	§ 1.120(b)	
§ 1.100(b)(3)	§ 1.120(c)	
§ 1.100(b)(4)	§ 1.120(d)	
§ 1.110	§ 1.130	Modified.
	§ 1.120(f)	Removed.
	§ 1.120(g)	Removed.
§ 1.120	§ 1.120(e)	
§ 1.130(a)	§ 1.140(a)	Modified.
§ 1.130(b)	§ 1.140(b)	
§ 1.130(c)	§ 1.140(c)	Modified.

Regulatory Flexibility Act

It is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This regulation will reduce the regulatory burden on national banks, regardless of size, by simplifying and clarifying existing regulatory requirements.

Paperwork Reduction Act of 1995

The OCC invites comments on:

(1) Whether the collections of information contained in this notice of final rule are necessary for the proper performance of OCC functions, including whether the information has practical utility;

(2) The accuracy of the estimate of the burden of the information collections;

(3) Ways to enhance the quality, utility, and clarity of the information to be collected;

(4) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and

(5) Estimates of capital or startup costs and costs of operation, maintenance, and purchase of services to provide information.

Respondents/recordkeepers are not required to respond to these collections of information unless this displays a currently valid OMB control number.

The collection of information requirements contained in this final rule have been approved by the Office of Management and Budget under OMB control number 1557–0205 in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Paperwork Reduction Project (1557–0205), Washington, DC 20503, with copies to the Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

The collection of information requirements in this final rule are found in 12 CFR 1.3 and 1.7. This information is required to enable the OCC to make determinations as to the safety and soundness of activities. The likely respondents/recordkeepers are national banks.

Estimated average annual burden hours per respondent/recordkeeper: 18.4 hours.

Estimated number of respondents and/or recordkeepers: 25.

Estimated total annual reporting and recordkeeping burden: 460 hours.

Start-up costs to respondents: None.

Executive Order 12866

The OCC has determined that this final rule is not a significant regulatory action.

Unfunded Mandates Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995 (Unfunded Mandates Act) (signed into law on March 22, 1995) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. If a budgetary impact statement is required, Section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. Because the OCC has determined that this final rule will not result in expenditures by State, local, and tribal governments or by the private sector of $100 million or more in any one year, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered. Nevertheless, as discussed in the preamble, the final rule has the effect of reducing burden and increasing the discretion of national banks regarding their sound investment activities.

List of Subjects

12 CFR Part 1

Banks, banking, National banks, Reporting and recordkeeping requirements, Securities.

12 CFR Part 7

Credit, Insurance, Investments, National banks, Reporting and recordkeeping requirements, Securities, Surety bonds.

Authority and Issuance

For the reasons set out in the preamble, chapter I of title 12 of the Code of Federal Regulations is amended as set forth below:

1. Part 1 is revised to read as follows:

PART 1—INVESTMENT SECURITIES

Authority: 12 U.S.C. 1 *et seq.*, 24 (Seventh), and 93a.

§ 1.1 Authority, purpose, and scope.

(a) *Authority.* This part is issued pursuant to 12 U.S.C. 1 *et seq.*, 12 U.S.C. 24 (Seventh), and 12 U.S.C. 93a.

(b) *Purpose* This part prescribes standards under which national banks may purchase, sell, deal in, underwrite, and hold securities, consistent with the authority contained in 12 U.S.C. 24 (Seventh) and safe and sound banking practices.

(c) *Scope.* The standards set forth in this part apply to national banks, District of Columbia banks, and federal branches of foreign banks. Further, pursuant to 12 U.S.C. 335, State banks that are members of the Federal Reserve System are subject to the same limitations and conditions that apply to national banks in connection with purchasing, selling, dealing in, and underwriting securities and stock. In addition to activities authorized under this part, foreign branches of national banks are authorized to conduct international activities and invest in securities pursuant to 12 CFR part 211.

§ 1.2 Definitions.

(a) *Capital and surplus* means:

(1) A bank's Tier 1 and Tier 2 capital calculated under the OCC's risk-based capital standards set forth in appendix A to 12 CFR part 3 (or comparable capital guidelines of the appropriate Federal banking agency) as reported in the bank's Consolidated Report of Condition and Income filed under 12 U.S.C. 161 (or under 12 U.S.C. 1817 in the case of a state member bank); plus

(2) The balance of a bank's allowance for loan and lease losses not included in the bank's Tier 2 capital, for purposes of the calculation of risk-based capital described in paragraph (a)(1) of this section, as reported in the bank's Consolidated Report of Condition and Income filed under 12 U.S.C. 161 (or under 12 U.S.C. 1817 in the case of a state member bank).

(b) *General obligation of a State or political subdivision* means:

(1) An obligation supported by the full faith and credit of an obligor possessing general powers of taxation, including property taxation; or

(2) An obligation payable from a special fund or by an obligor not possessing general powers of taxation, when an obligor possessing general powers of taxation, including property taxation, has unconditionally promised to make payments into the fund or otherwise provide funds to cover all required payments on the obligation.

(c) *Investment company* means an investment company, including a mutual fund, registered under section 8 of the Investment Company Act of 1940, 15 U.S.C. 80a–8.

(d) *Investment grade* means a security that is rated in one of the four highest rating categories by:

(1) Two or more NRSROs; or

(2) One NRSRO if the security has been rated by only one NRSRO.

(e) *Investment security* means a marketable debt obligation that is not predominantly speculative in nature. 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.

(f) *Marketable* means that the security:

(1) Is registered under the Securities Act of 1933, 15 U.S.C. 77a *et seq.*;

(2) Is a municipal revenue bond exempt from registration under the Securities Act of 1933, 15 U.S.C. 77c(a)(2);

(3) Is offered and sold pursuant to Securities and Exchange Commission Rule 144A, 17 CFR 230.144A, and rated investment grade or is the credit equivalent of investment grade; or

(4) Can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

(g) *NRSRO* means a nationally recognized statistical rating organization.

(h) *Political subdivision* means a county, city, town, or other municipal corporation, a public authority, and generally any publicly-owned entity that is an instrumentality of a State or of a municipal corporation.

(i) *Type I security* means:

(1) Obligations of the United States;

(2) Obligations issued, insured, or guaranteed by a department or an agency of the United States Government, if the obligation, insurance, or guarantee commits the full faith and credit of the United States for the repayment of the obligation;

(3) Obligations issued by a department or agency of the United States, or an agency or political subdivision of a State of the United States, that represent an interest in a loan or a pool of loans made to third parties, if the full faith and credit of the United States has been validly pledged for the full and timely payment of interest on, and principal of, the loans in the event of non-payment by the third party obligor(s);

(4) General obligations of a State of the United States or any political subdivision;

(5) Obligations authorized under 12 U.S.C. 24 (Seventh) as permissible for a national bank to deal in, underwrite, purchase, and sell for the bank's own account, including qualified Canadian government obligations; and

(6) Other securities the OCC determines to be eligible as Type I securities under 12 U.S.C. 24 (Seventh).

(j) *Type II security* means an investment security that represents:

(1) Obligations issued by a State, or a political subdivision or agency of a State, for housing, university, or dormitory purposes;

(2) Obligations of international and multilateral development banks and organizations listed in 12 U.S.C. 24 (Seventh);

(3) Other obligations listed in 12 U.S.C. 24 (Seventh) as permissible for a bank to deal in, underwrite, purchase, and sell for the bank's own account, subject to a limitation per obligor of 10 percent of the bank's capital and surplus; and

(4) Other securities the OCC determines to be eligible as Type II securities under 12 U.S.C. 24 (Seventh).

(k) *Type III security* means an investment security that does not qualify as a Type I, II, IV, or V security, such as corporate bonds and municipal revenue bonds.

(l) *Type IV security* means:

(1) A small business-related security as defined in section 3(a)(53)(A) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(53)(A), that is rated investment grade or is the credit equivalent thereof, that is fully secured by interests in a pool of loans to numerous obligors.

(2) A commercial mortgage-related security that is offered or sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5), that is rated investment grade or is the credit equivalent thereof, or a commercial mortgage-related security as described in section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41), that is rated investment grade in one of the two highest investment grade rating categories, and that represents ownership of a promissory note or certificate of interest or participation that is directly secured by a first lien on one or more parcels of real estate upon which one or more commercial structures are located and that is fully secured by interests in a pool of loans to numerous obligors.

(3) A residential mortgage-related security that is offered and sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5), that is rated investment grade or is the credit equivalent thereof, or a residential mortgage-related security as described in section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41)), that is rated investment

grade in one of the two highest investment grade rating categories, and that does not otherwise qualify as a Type I security.

(m) *Type V security* means a security that is:

(1) Rated investment grade;

(2) Marketable;

(3) Not a Type IV security; and

(4) Fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest directly.

§ 1.3 Limitations on dealing in, underwriting, and purchase and sale of securities.

(a) *Type I securities.* A national bank may deal in, underwrite, purchase, and sell Type I securities for its own account. The amount of Type I securities that the bank may deal in, underwrite, purchase, and sell is not limited to a specified percentage of the bank's capital and surplus.

(b) *Type II securities.* A national bank may deal in, underwrite, purchase, and sell Type II securities for its own account, provided the aggregate par value of Type II securities issued by any one obligor held by the bank does not exceed 10 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type II securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

(c) *Type III securities.* A national bank may purchase and sell Type III securities for its own account, provided the aggregate par value of Type III securities issued by any one obligor held by the bank does not exceed 10 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type III securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

(d) *Type II and III securities; other investment securities limitations.* A national bank may not hold Type II and III securities issued by any one obligor with an aggregate par value exceeding 10 percent of the bank's capital and surplus. However, if the proceeds of each issue are to be used to acquire and lease real estate and related facilities to economically and legally separate industrial tenants, and if each issue is payable solely from and secured by a first lien on the revenues to be derived from rentals paid by the lessee under net noncancellable leases, the bank may apply the 10 percent investment limitation separately to each issue of a single obligor.

(e) *Type IV securities*—(1) *General.* A national bank may purchase and sell Type IV securities for its own account. A national bank may deal in Type IV securities that are fully secured by Type I securities. Except as described in paragraph (e)(2) of this section, the amount of the Type IV securities that a bank may purchase and sell is not limited to a specified percentage of the bank's capital and surplus.

(2) *Limitation on small business-related securities rated in the third and fourth highest rating categories by an NRSRO.* A national bank may hold small business-related securities, as defined in section 3(a)(53)(A) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(53)(A), of any one issuer with an aggregate par value not exceeding 25 percent of the bank's capital and surplus if those securities are rated investment grade in the third or fourth highest investment grade rating categories. In applying this limitation, a national bank shall take account of securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings. No percentage of capital and surplus limit applies to small business related securities rated investment grade in the highest two investment grade rating categories.

(f) *Type V securities.* A national bank may purchase and sell Type V securities for its own account provided that the aggregate par value of Type V securities issued by any one issuer held by the bank does not exceed 25 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type V securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

(g) *Securitization.* A national bank may securitize and sell assets that it holds, as a part of its banking business. The amount of securitized loans and obligations that a bank may sell is not limited to a specified percentage of the bank's capital and surplus.

(h) *Investment company shares*—(1) *General.* A national bank may purchase and sell for its own account investment company shares provided that:

(i) The portfolio of the investment company consists exclusively of assets that the national bank may purchase and sell for its own account under this part; and

(ii) The bank's holdings of investment company shares do not exceed the limitations in § 1.4(e).

(2) *Other issuers.* The OCC may determine that a national bank may invest in an entity that is exempt from registration as an investment company under section 3(c)(1) of the Investment Company Act of 1940, provided that the portfolio of the entity consists exclusively of assets that a national bank may purchase and sell for its own account under this part.

(i) *Securities held based on estimates of obligor's performance.* (1) Notwithstanding §§ 1.2(d) and (e), a national bank may treat a debt security as an investment security for purposes of this part if the bank concludes, on the basis of estimates that the bank reasonably believes are reliable, that the obligor will be able to satisfy its obligations under that security, and the bank believes that the security may be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

(2) The aggregate par value of securities treated as investment securities under paragraph (i)(1) of this section may not exceed 5 percent of the bank's capital and surplus.

§ 1.4 Calculation of limits.

(a) *Calculation date.* For purposes of determining compliance with 12 U.S.C. 24 (Seventh) and this part, a bank shall determine its investment limitations as of the most recent of the following dates:

(1) The last day of the preceding calendar quarter; or

(2) The date on which there is a change in the bank's capital category for purposes of 12 U.S.C. 1831o and 12 CFR 6.3.

(b) *Effective date.* (1) A bank's investment limit calculated in accordance with paragraph (a)(1) of this section will be effective on the earlier of the following dates:

(i) The date on which the bank's Consolidated Report of Condition and Income (Call Report) is submitted; or

(ii) The date on which the bank's Consolidated Report of Condition and Income is required to be submitted.

(2) A bank's investment limit calculated in accordance with paragraph (a)(2) of this section will be effective on the date that the limit is to be calculated.

(c) *Authority of OCC to require more frequent calculations.* If the OCC determines for safety and soundness reasons that a bank should calculate its investment limits more frequently than required by paragraph (a) of this section, the OCC may provide written notice to the bank directing the bank to calculate its investment limitations at a more frequent interval. The bank shall thereafter calculate its investment limits at that interval until further notice.

(d) *Calculation of Type III and Type V securities holdings*—(1) *General.* In calculating the amount of its investment in Type III or Type V securities issued by any one obligor, a bank shall aggregate:

(i) Obligations issued by obligors that are related directly or indirectly through common control; and

(ii) Securities that are credit enhanced by the same entity.

(2) *Aggregation by type.* The aggregation requirement in paragraph (d)(1) of this section applies separately to the Type III and Type V securities held by a bank.

(e) *Limit on investment company holdings*—(1) *General.* In calculating the amount of its investment in investment company shares under this part, a bank shall use reasonable efforts to calculate and combine its pro rata share of a particular security in the portfolio of each investment company with the bank's direct holdings of that security. The bank's direct holdings of the particular security and the bank's pro rata interest in the same security in the investment company's portfolio may not, in the aggregate, exceed the investment limitation that would apply to that security.

(2) *Alternate limit for diversified investment companies.* A national bank may elect not to combine its pro rata interest in a particular security in an investment company with the bank's direct holdings of that security if:

(i) The investment company's holdings of the securities of any one issuer do not exceed 5 percent of its total portfolio; and

(ii) The bank's total holdings of the investment company'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.

§ 1.5 Safe and sound banking practices; credit information required.

(a) A national bank shall adhere to safe and sound banking practices and the specific requirements of this part in conducting the activities described in § 1.3. The bank shall consider, as appropriate, the interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risks presented by a proposed activity, and the particular activities undertaken by the bank must be appropriate for that bank.

(b) In conducting these activities, the bank shall determine that there is adequate evidence that an obligor possesses resources sufficient to provide for all required payments on its obligations, or, in the case of securities deemed to be investment securities on the basis of reliable estimates of an obligor's performance, that the bank reasonably believes that the obligor will be able to satisfy the obligation.

(c) Each bank shall maintain records available for examination purposes adequate to demonstrate that it meets the requirements of this part. The bank may store the information in any manner that can be readily retrieved and reproduced in a readable form.

§ 1.6 Convertible securities.

A national bank may not purchase securities convertible into stock at the option of the issuer.

§ 1.7 Securities held in satisfaction of debts previously contracted; holding period; disposal; accounting treatment; non-speculative purpose.

(a) *Securities held in satisfaction of debts previously contracted.* The restrictions and limitations of this part, other than those set forth in paragraphs (b),(c), and (d) of this section, do not apply to securities acquired:

(1) Through foreclosure on collateral;

(2) In good faith by way of compromise of a doubtful claim; or

(3) To avoid loss in connection with a debt previously contracted.

(b) *Holding period.* A national bank holding securities pursuant to paragraph (a) of this section may do so for a period not to exceed five years from the date that ownership of the securities was originally transferred to the bank. The OCC may extend the holding period for up to an additional five years if a bank provides a clearly convincing demonstration as to why an additional holding period is needed.

(c) *Accounting treatment.* A bank shall account for securities held pursuant to paragraph (a) of this section in accordance with Generally Accepted Accounting Principles.

(d) *Non-speculative purpose.* A bank may not hold securities pursuant to paragraph (a) of this section for speculative purposes.

§ 1.8 Nonconforming investments.

(a) A national bank's investment in securities that no longer conform to this part but conformed when made will not be deemed in violation but instead will be treated as nonconforming if the reason why the investment no longer conforms to this part is because:

(1) The bank's capital declines;

(2) Issuers, obligors, or credit-enhancers merge;

(3) Issuers become related directly or indirectly through common control;

(4) The investment securities rules change;

(5) The security no longer qualifies as an investment security; or

(6) Other events identified by the OCC occur.

(b) A bank shall exercise reasonable efforts to bring an investment that is nonconforming as a result of events described in paragraph (a) of this section into conformity with this part unless to do so would be inconsistent with safe and sound banking practices.

Interpretations

§ 1.100 Indirect general obligations.

(a) *Obligation issued by an obligor not possessing general powers of taxation.* Pursuant to § 1.2(b), an obligation issued by an obligor not possessing general powers of taxation qualifies as a general obligation of a State or political subdivision for the purposes of 12 U.S.C. 24 (Seventh), if a party possessing general powers of taxation unconditionally promises to make sufficient funds available for all required payments in connection with the obligation.

(b) *Indirect commitment of full faith and credit.* The indirect commitment of the full faith and credit of a State or political subdivision (that possesses general powers of taxation) in support of an obligation may be demonstrated by any of the following methods, alone or in combination, when the State or political subdivision pledges its full faith and credit in support of the obligation.

(1) *Lease/rental agreement.* The lease agreement must be valid and binding on the State or the political subdivision, and the State or political subdivision must unconditionally promise to pay rentals that, together with any other available funds, are sufficient for the timely payment of interest on, and principal of, the obligation. These lease/rental agreement may, for instance, provide support for obligations financing the acquisition or operation of public projects in the areas of education, medical care, transportation, recreation, public buildings, and facilities.

(2) *Service/purchase agreement.* The agreement must be valid and binding on the State or the political subdivision, and the State or political subdivision must unconditionally promise in the agreement to make payments for services or resources provided through or by the issuer of the obligation. These payments, together with any other available funds, must be sufficient for the timely payment of interest on, and principal of, the obligation. An agreement to purchase municipal sewer, water, waste disposal, or electric services may, for instance, provide support for obligations financing the construction or acquisition of facilities supplying those services.

(3) *Refillable debt service reserve fund.* The reserve fund must at least equal the amount necessary to meet the annual payment of interest on, and principal of, the obligation as required by applicable law. The maintenance of a refillable reserve fund may be provided, for instance, by statutory direction for an appropriation, or by statutory automatic apportionment and payment from the State funds of amounts necessary to restore the fund to the required level.

(4) *Other grants or support.* A statutory provision or agreement must unconditionally commit the State or the political subdivision to provide funds which, together with other available funds, are sufficient for the timely payment of interest on, and principal of, the obligation. Those funds may, for instance, be supplied in the form of annual grants or may be advanced whenever the other available revenues are not sufficient for the payment of principal and interest.

§ 1.110 Taxing powers of a State or political subdivision.

(a) An obligation is considered supported by the full faith and credit of a State or political subdivision possessing general powers of taxation when the promise or other commitment of the State or the political subdivision will produce funds, which (together with any other funds available for the purpose) will be sufficient to provide for all required payments on the obligation. In order to evaluate whether a commitment of a State or political subdivision is likely to generate sufficient funds, a bank shall consider the impact of any possible limitations regarding the State's or political subdivision's taxing powers, as well as the availability of funds in view of the projected revenues and expenditures. Quantitative restrictions on the general powers of taxation of the State or political subdivision do not necessarily mean that an obligation is not supported by the full faith and credit of the State or political subdivision. In such case, the bank shall determine the eligibility of obligations by reviewing, on a case-by-case basis, whether tax revenues available under the limited taxing powers are sufficient for the full and timely payment of interest on, and principal of, the obligation. The bank shall use current and reasonable financial projections in calculating the availability of the revenues. An obligation expressly or implicitly dependent upon voter or legislative authorization of appropriations may be considered supported by the full faith and credit of a State or political subdivision if the bank determines, on the basis of past actions by the voters or legislative body in similar situations involving similar types of projects, that it is reasonably probable that the obligor will obtain all necessary appropriations.

(b) An obligation supported exclusively by excise taxes or license fees is not a general obligation for the purposes of 12 U.S.C. 24 (Seventh). Nevertheless, an obligation that is primarily payable from a fund consisting of excise taxes or other pledged revenues qualifies as a ''general obligation,'' if, in the event of a deficiency of those revenues, the obligation is also supported by the general revenues of a State or a political subdivision possessing general powers of taxation.

§ 1.120 Prerefunded or escrowed bonds and obligations secured by Type I securities.

(a) An obligation qualifies as a Type I security if it is secured by an escrow fund consisting of obligations of the United States or general obligations of a State or a political subdivision, and the escrowed obligations produce interest earnings sufficient for the full and timely payment of interest on, and principal of, the obligation.

(b) If the interest earnings from the escrowed Type I securities alone are not sufficient to guarantee the full repayment of an obligation, a promise of a State or a political subdivision possessing general powers of taxation to maintain a reserve fund for the timely payment of interest on, and principal of, the obligation may further support a guarantee of the full repayment of an obligation.

(c) An obligation issued to refund an indirect general obligation may be supported in a number of ways that, in combination, are sufficient at all times to support the obligation with the full faith and credit of the United States or a State or a political subdivision possessing general powers of taxation. During the period following its issuance, the proceeds of the refunding obligation may be invested in U.S. obligations or municipal general obligations that will produce sufficient interest income for payment of principal and interest. Upon the retirement of the outstanding indirect general obligation bonds, the same indirect commitment, such as a lease agreement or a reserve fund, that supported the prior issue, may support the refunding obligation.

§ 1.130 Type II securities; guidelines for obligations issued for university and housing purposes.

(a) *Investment quality.* An obligation issued for housing, university, or dormitory purposes is a Type II security only if it:

(1) Qualifies as an investment security, as defined in § 1.2(e); and

(2) Is issued for the appropriate purpose and by a qualifying issuer.

(b) *Obligation issued for university purposes.* (1) An obligation issued by a State or political subdivision or agency of a State or political subdivision for the purpose of financing the construction or improvement of facilities at or used by a university or a degree-granting college-level institution, or financing loans for studies at such institutions, qualifies as a Type II security. Facilities financed in this manner may include student buildings, classrooms, university utility buildings, cafeterias, stadiums, and university parking lots.

(2) An obligation that finances the construction or improvement of facilities used by a hospital may be eligible as a Type II security, if the hospital is a department or a division of a university, or otherwise provides a nexus with university purposes, such as an affiliation agreement between the university and the hospital, faculty positions of the hospital staff, and training of medical students, interns, residents, and nurses (*e.g.*, a ''teaching hospital'').

(c) *Obligation issued for housing purposes.* An obligation issued for housing purposes may qualify as a Type II security if the security otherwise meets the criteria for a Type II security.

PART 7—INTERPRETIVE RULINGS

2. The authority citation for part 7 continues to read as follows:

Authority: 12 U.S.C. 1 *et seq.* and 93a.

§ 7.1021 [Removed]

3. Section 7.1021 is removed.

Dated: November 22, 1996.

Eugene A. Ludwig,

Comptroller of the Currency.

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