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Bank and BHC Investments in Debt and Equity of UFIs: Road Map for Managing Investments in an Evolving Market

Bank holding companies, savings and loan holding companies, and their depository institution subsidiaries are considering strategies to enhance net interest income through debt and debt-equivalent equity investments in unconsolidated financial institutions (UFIs). Due to evolving regulatory and accounting rules and regulations, there are a number of key questions to be addressed by Non-Advanced Approaches Banks (NAABs)[1] as they contemplate making such investments including:

- How should investments in UFIs be underwritten?
- Should the UFI investment be booked as a loan or security?
- Should the UFI investment be booked at the bank or BHC level?
- How much can be invested at the bank level? At the BHC level?
- How can the bank or BHC provide support for marketability of the UFI investment?

This report is intended to be a roadmap for bank management teams and their boards of directors as they navigate these questions to underwrite, buy and sell debt and equity issued by UFIs.

Debt investments can be underwritten either as loans or investment securities as follows:

- *Investments that are determined to be investment grade equivalent in quality and marketable can be purchased as securities and would be subject to the bank's investment policy and limits.*
- *Investments that are not determined to be marketable would have to be underwritten as loans under the bank's lending authority to "buy and negotiate debt" and would be subject to the bank's loan underwriting policy and legal lending limits.*
- *UFI investments originally acquired and booked as securities would remain classified as securities. If subsequent experience led the buyer to believe that the security did not conform with the marketability requirements, it would either need to be brought into conformity with documentation of liquidity or it would be considered non-conforming with remedial action required as described herein.*

[1] Non-advanced approaches banks include all banks except those determined to be Advanced Approaches banks. There are currently only nine banks Advanced Approaches U.S. banks consisting of eight Category I and one Category II banks. The eight Category I banks currently include the U.S Global Systemically Important Banks ("GSIBs") Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo. There is a single Category II banking organization, Northern Trust Corporation, that has $700 billion or more in assets or $100 billion or more in assets and $75 billion or more in cross jurisdictional activity.

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Debt-equivalent preferred equity investments may also be purchased at the bank level but should be underwritten as investment securities subject to the investment policy limits and restrictions for such securities.

While the rules for determining permissibility of investments have not changed, two recent regulatory rule changes have affected the aggregate amount and type of investments that NAABs can make in UFIs.

- First, effective April 1, 2020, (early adoption permitted January 1, 2020), the Basel III Simplification Final Rule significantly increased the common equity tier 1 (CET1) capital threshold deductions from 10% to 25% for amount of investment that NAABs can hold in the debt and equity capital of UFIs. The final rule also removed the need to distinguish between non-significant and significant investments in UFIs and instead changed the decision framework for NAABs to debt investment vs. equity investment. Advanced Approaches Banks are still required to use the Basel III "significant vs non-significant investment" framework.

- Second, effective September 30, 2020, the Federal Reserve provided more transparency on the presumptions of control codified in Regulation Y and Regulation LL related to an equity investment. These clarifications provide more certainty on the amount of equity investments and non-investment relationships that will impact presumptions of control.

Taken together, these changes have the potential to significantly increase the aggregate amount of debt and equity investment in UFIs made by NAABs.

While the Basel III Simplification Final Rule increased aggregate investment amounts in UFIs from 10% to 25% of CET1 for NAABs, each bank-level investment in a debt or debt-equivalent security must first be assessed to confirm that it is a permissible investment that is (i) investment grade equivalent in credit quality, (ii) marketable, and (iii) not speculative. A strong secondary market has developed for debt and debt-equivalent capital securities issued by banks in private placements, 144A offerings, and registered offerings, such that these securities (regardless of issuance format) can generally be sold at pricing that reasonably approximates fair value. Banks active in investing in such securities must document their evaluation of the credit quality of the investment as well as the liquidity of the investment.

The investment amount per issuer at the bank level is limited to 10% of capital and surplus for debt and preferred stock that is determined to be a fixed income equivalent. While 10% of capital and surplus is the maximum possible, we understand that the regulators expect that banking institutions will have very few if any single issuer investment exposures at that level. Other than certain types of preferred stock that have been determined by the OCC to be debt-equivalent, preferred stock and other equity investments in UFIs would typically be booked at the BHC level where the amount of voting securities and aggregate equity ownership are primary determinants of control. However, there are a limited number of states where bank level ownership of common equity securities of UFI's is permitted. The BHC is expected to be a source of strength for the bank and maintain adequate income and cash flow, which ultimately limits the amount of non-investment grade illiquid investments that can be held at the BHC level.

For ease of reference, we have organized the remainder of this report into four sections as follows:

- Individual investment underwriting requirements and limits;
- Aggregate investment limits for NAABs;
- Permitted investment in equities; and
- Aggregate investment limits for Advanced Approaches banks.

Individual Investment Underwriting Requirements and Limits

Chart A: Determining Permissibility of an Investment

Investment Grade Equivalent	***Marketable Security***	***Capital and Surplus***
• *Issuer has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure and* • *Issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.*	• *Registered under the Securities Act of 1933;* • *Municipal revenue bond exempt from registration;* • *Offered and sold pursuant to SEC Rule144A and investment grade equivalent; or* • *Can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.*	• ***For CBLR banks: tier 1 capital plus ALLL or ACL as appropriate*** • ***For all other banks: tier 1 and tier 2 capital plus ALLL or ACL as appropriate plus the balance of ALLL or ACL not included in tier 2 capital for the bank's RWA calculation*** • ***Debt limit = 10%*** • ***Preferred limit = 10%***

The Dodd-Frank Act (Section 939A) eliminated references to credit ratings which resulted in the OCC, FDIC and Federal Reserve publishing regulations and guidance on alternative uniform standards of creditworthiness. As noted above in Chart A, investment grade equivalent means the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default is low and the full and timely repayment of the principal and interest is expected.[2]

The OCC has determined that national banks may invest in investment grade equivalent corporate debt securities that are marketable and not predominantly speculative in nature. Total investments in any one issuer cannot exceed 10% of capital and surplus.[3] As noted earlier, this limit is not an authorization to hold investments of 10% of capital and surplus. If a bank held multiple such 10% investments, it may be viewed as having a concentration concern and may receive examiner scrutiny. Each investment must have appropriate documented due diligence and credit analysis. The bank must also consider whether it is holding sufficient capital against these investments to factor in other risks such as changes in interest rates.

Three of the four tests for marketability (SEC registered, municipal bond, or 144A) can be objectively measured. The fourth standard requires that the security be able to be sold with ***reasonable promptness at a price that corresponds reasonably to its fair value***. Since these four tests for the Part 1 standard for marketability were published on June 13, 2012, the market for UFI securities has evolved whereby private placements have arguably supplanted 144A offerings in terms of marketability and liquidity. Private placements may be sold to accredited

[2] Federal Register. Volume 77, No. 114, June 13, 2012, page 35254.

[3] 12 CFR Section 1.2. "Capital and surplus" means for qualifying community banking organizations that have elected to use the CBLR framework: tier 1 capital plus allowance for loan and lease losses or adjusted allowance for credit losses as applicable. For all other banks: tier 1 and tier 2 capital calculated under the OCC's risk-based capital standard plus the balance of the bank's allowance for loan and lease losses or adjusted allowances for credit losses (as applicable) not included in the bank's tier 2 capital for purposes of the bank's calculation of risk-based capital.

investors and Qualified Institutional Buyers (QIBs) while 144A transactions are typically only sold to QIBs. If a bank chooses to purchase and hold bank subordinated debt as a security, it must be prepared to demonstrate to its examiners that the bank subordinated debt is a permissible investment (including with respect to marketability), and must document the sources of potential liquidity of their investments just as they would document the evaluation of the credit.

The primary market for bank subordinated debt and other capital securities has developed significantly since 2014. This market is divided by market participants into two segments, the $40 billion in assets and below market (Community & Regional Bank Market) and the large bank market exceeding $40 billion in assets. Within the Community & Regional Bank Market, the market is further divided into the $10 million and above issuance market and the below $10 million market. Investment grade placements are now being completed for regional and community banks through private placements, 144A offerings and publicly registered offerings.

As shown in Chart B below, from January 1, 2014 to April 2, 2021, there has been a total of $25.4 billion of subordinated debt issued by community and regional banks. Of this amount, 70% of the issuance dollars were done publicly either through publicly registered offerings or private placements with registration rights. Approximately 30% of the issuance dollars were private placement with 28% being sold in offerings greater than $10 billion and 2% of dollars sold in offerings below $10 million.

Chart B: Select Community & Regional Bank Debt Issuances (Issuers < $40 B in Assets)

	$Millions	Number of Offerings	Percentage Dollars	Percentage Number
$10M or More				
Public	$15,961	141	63%	26%
Reg Rights	$1,741	40	7%	7%
Private	$6,827	305	28%	54%
Below $10M				
Private	$453	66	2%	12%
Total	**$25,378**	**537**	**100%**	**100%**

Sources: Piper Sandler & Co. Debt Capital Markets Desk, S&P Global Market Intelligence, Bloomberg

As such, the below $10 million segment is a fraction of the Community & Regional Bank Market. Issuances in this segment are typically non-rated and underwritten as loans by bank purchasers, which removes any uncertainty as to whether the subordinated debt would be a permissible investment if purchased and held as a security.

A strong secondary market has also developed for bank subordinated debt and other capital securities issued as private placements, 144A and registered offerings such that, absent a temporary global market disruption, these securities can generally be sold at pricing that reasonably approximates fair value. For example, other than a few instances of market volatility since the Great Financial Recession, such as in Q1 of 2016 when oil traded at less than $30 per barrel, in December of 2018 (steep decline in the equity markets/Chinese economic concerns), and March/April of 2020 with the onset of COVID-19 whereby substantially all credit markets seized up, there has been a deep secondary market for community bank subordinated debt in which there are at least 12-15 broker-dealers that make markets and bid for bonds regularly when they become available in the secondary market. There is intense competition in the secondary market from both bulge bracket firms as well as a wide swath of financial services specialist firms.

In Piper Sandler's distribution system alone, there are greater than 525 institutional investors that have participated in our community bank sub-debt franchise since the inception of the market. Since June of 2014, that number has steadily increased on a monthly basis as new investors have emerged to buy good community bank capital securities that provide anywhere from 150-450 basis points of incremental yield versus money-center and super-regional bank debt, depending on the particular transaction. Within this framework, we have more than 350 banks, 125 asset managers and 50 insurance companies that constitute the three main groupings within the institutional investor group. Typically when capital securities become available for sale in the secondary market, the turnaround time for sale is efficient and expeditious, generally within an hour or within the same business day depending on the particular security and the deal specifics (such as size of deal, whether it is rated, how many investors participated in the original offering, etc.).

All of Piper Sandler's primary deals are quoted on Bloomberg with all of the relevant structural and pricing details in order for investors to quickly ascertain whether or not it fits their investment parameters. Not only does Bloomberg have a valuation on each security, but other valuation firms such as IDC and the NYSE (ICE) provide monthly mark-to-market services that are requested by a number of our institutional purchasers. In addition, Piper Sandler provides and maintains a secondary market on all our deals. We have a deep and dedicated trading desk focused on this effort. We also have two full time research professionals who provide research and credit support on all our deals, both in primary marketing in the new issue phase as well as in the secondary market. We believe that taken together, these full service efforts from origination, credit underwriting, Bloomberg listing, monthly valuation services, and secondary market trading ensure that securities can be sold with reasonable promptness at a price that corresponds reasonably to their fair value.[4]

Since it is unlikely that the OCC will revise the four-part standard for determining marketability, prudent bank management should be prepared to document the marketability and liquidity of their investments. As highlighted in Chart C below, here are a number of elements that can be used to support marketability for a UFI investment including the following:

Chart C: Key Elements Supporting Marketability of Investment in UFIs

- Third party investment grade debt rating;
- Rating agency provides periodic research reports updating status of credit;
- Diligence evidencing debt coverage, double leverage, and underlying credit quality
- Regulation D offering cleared through DTC, which provides a mechanism for simple secondary transfer;
- Regulation D with registration rights, which results in the securities becoming exchanged for registered securities in a relatively short period of time after issuance;
- Offering quoted on Bloomberg;
- Offering supported by 2 or more market makers;
- Periodic secondary market sales of securities;
- Monthly valuation provided by IDC or the NYSE (ICE);
- Issuer covered by equity research;
- Documentation of number and type of investors; and
- Maintaining copy of original due diligence, investor presentation and quarterly updated financial information.

[4] Commentary from Piper Sandler & Co. debt capital markets trading desk, March 2021.

Bank portfolio managers should consider creating a documentation file with the marketability information described above in Chart C and updating this information at least quarterly or as more recent information becomes available.

Keep in mind that banking organizations can still invest in UFI debt and debt-equivalent preferred securities that are not determined to be marketable. Such securities would have to be underwritten as loans under the bank's lending authority to "buy and negotiate debt" and would be subject to the bank's loan underwriting policy and legal lending limits. UFI investments with a CUSIP would not require treatment as a security but can be underwritten as loans under the "buy and negotiate debt" authority. OCC advisory Bulletin 2020-81, effective September 10, 2020, provides a useful reference guide for loan purchase activities including lending policies and procedures and credit administration applicable to investment in UFIs underwritten as loans. Please see Appendix B for a summary of key risk management practices for loan purchase activity from this advisory Bulletin.

From our recent discussions with senior OCC regulatory staff, we understand, however, that UFI investments originally acquired and booked as securities would remain classified as securities. If subsequent experience led the buyer to believe that the security did not conform with the marketability requirements, it could be viewed as a non-conforming investment. While a limited amount of non-conforming investments may be maintained in the securities portfolio, any significant amounts would either need to be brought into conformity with documentation of liquidity as noted above or a plan would need to be developed to either sell the security or re-underwrite it as a loan under the bank's lending authority.

There is an apparent inconsistency between the OCC's lending authority to "buy and negotiate debt" underwritten as a loan and the OCC's August 2020 accounting guidance in which the OCC states that pursuant to ASC 320, investment in trust preferred securities should be classified and reported as securities on the bank's financial statements including call reports. The legal means for acquiring the security is not relevant for the accounting treatment. The financial statement classification is governed by GAAP, not the legal authority under which assets are purchased. The trust preferred securities are debt securities subject to the accounting requirements of ASC 320.[5] This implies that even if an investment is legally underwritten as a loan, it would have to be booked as a security to comply with ASC 320.

However, there is a difference between the legal authority through which a loan or security is underwritten and the accounting requirements for how the investment is booked for the call report and GAAP financial statements. All UFI investments purchases must be underwritten either as loans or securities pursuant to the bank's or the BHC's internal policies. For more information on the underwriting authority for bank loan or security investments please see Chart D below.

Under 12 CFR 1, 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. The investment qualifications and limits by type of investment are shown in Chart D below with the type of investment on the y-axis and the type of security on the x-axis. We have focused on the most typical types of UFI securities, including corporate subordinated debt, trust preferred, and preferred stock. Investments in UFIs underwritten as loans are subject to different requirements than UFIs underwritten as securities. The differences in specific rules, regulations and OCC interpretive letters that authorized such investment at the bank level as loans are highlighted in the orange "Loan" column while the applicable requirements for securities are highlighted under columns under "Security".

[5] Bank Accounting Advisory Series. Office of the Comptroller of the Currency. August 2020. Question 11. Page 5.

Chart D: Permitted Bank Level UFI Investment Grid

Bank Level -- UFI Investment Grid

BANK LEVEL	Loan	Security						
		Reg D		144A		Public Registration		
		IG (1)	Marketable (2)	IG (1)	Marketable (2)	IG (1)	Marketable (2)	Comments
Corporate Debt Securities - Max investment in any issuer of 10% of bank's capital and surplus (3)	12 USC 84; Bank Circular 2020-81; OCC interpretive Letter No. 908	12 USC 24 (seventh); 12 CFR 1.2(1), 1.3(c); CFR Part 1; OCC Interpretive Letter No. 777	12 USC 24 (seventh); 12 CFR 1.2(1), 1.3(c); CFR Part 1; OCC Interpretive Letter No. 777	12 USC 24 (seventh); 12 CFR 1.2(1), 1.3(c); CFR Part 1; OCC Interpretive Letter No. 777	12 USC 24 (seventh); 12 CFR 1.2(1), 1.3(c); CFR Part 1; OCC Interpretive Letter No. 777	12 USC 24 (seventh); 12 CFR 1.2(1), 1.3(c); CFR Part 1; OCC Interpretive Letter No. 777	12 USC 24 (seventh); 12 CFR 1.2(1), 1.3(c); CFR Part 1; OCC Interpretive Letter No. 777	**Corporate Debt Securities.** National banks may invest in any investment grade corporate debt security, provided the securities are marketable debt obligations that are not predominantly speculative in nature and total investments in any one issuer do not exceed 10 percent of the national bank's capital and surplus. 12 USC 24(Seventh); 12 CFR 1.2(l), 1.3(c).
Trust Preferred Securities - Max investment in any issuer of 10% of bank's capital and surplus (3)	12 USC 84; Bank Circular 2020-81; OCC interpretive Letter No. 908	12 CFR Part 1; OCC Interpretive Letter No. 777	12 CFR Part 1; OCC Interpretive Letter No. 777	12 CFR Part 1; OCC Interpretive Letter No. 777	12 CFR Part 1; OCC Interpretive Letter No. 777	12 CFR Part 1; OCC Interpretive Letter No. 777	12 CFR Part 1; OCC Interpretive Letter No. 777	**Trust Preferred Securities Purchased as Investment Securities or Loans.** National banks may invest in trust preferred securities that meet applicable rating and marketability requirements as Type III investment securities under 12 CFR Part 1. OCC Interpretive letter No. 777 (April 8, 1997). A national bank may purchase, under its lending authority, trust preferred securities that are not marketable and thus do not qualify as investment securities under 12 CFR Part 1, subject to the lending limits of 12 USC 84 and the requirements of Banking Circular 2020-81; and OCC Interpretive Letter No. 908 (April 23, 2001).
Preferred stock - Max investment in any issuer of 10% of bank's capital and surplus (3)(4)	12 USC 84; Bank Circular 2020-81; OCC interpretive Letter No. 908	12 CFR Part 1; OCC Interpretive Letter No. 777; OCC Interpretive Letter No. 941; and Interpretive Letter No. 781	12 CFR Part 1; OCC Interpretive Letter No. 777; OCC Interpretive Letter No. 941; and Interpretive Letter No. 781	12 CFR Part 1; OCC Interpretive Letter No. 777; OCC Interpretive Letter No. 941; and Interpretive Letter No. 781	12 CFR Part 1; OCC Interpretive Letter No. 777; OCC Interpretive Letter No. 941; and Interpretive Letter No. 781	12 CFR Part 1; OCC Interpretive Letter No. 777; OCC Interpretive Letter No. 941; and Interpretive Letter No. 781	12 CFR Part 1; OCC Interpretive Letter No. 777; OCC Interpretive Letter No. 941; and Interpretive Letter No. 781	**Acquisition of Preferred Stock of an Unaffiliated Company.** A national bank has authority to acquire and hold the preferred stock of an unaffiliated company, pursuant to its authority to discount and negotiate evidences of debt, where the preferred stock is in substance a debt obligation of the issuer. The bank acquired the preferred stock as partial consideration for the disposition of a loan portfolio to the company. The bank's existing holdings represent less than 5 percent of the bank's capital and surplus and are within applicable prudential standards and regulatory limits. OCC Interpretive Letter No. 941 (June 11, 2002).
Money Market Preferred Stock - Max investment in any issuer of 10% of bank's capital and surplus (3)(4)	12 USC 84; Bank Circular 2020-81; OCC interpretive Letter No. 908	OCC Interpretive Letter No. 781	OCC Interpretive Letter No. 781	OCC Interpretive Letter No. 781	OCC Interpretive Letter No. 781	OCC Interpretive Letter No. 781	OCC Interpretive Letter No. 781	**Money Market Preferred Stock.** National banks may invest in money market preferred stock as Type III investment securities, provided the investment is investment grade, marketable, and not predominantly speculative in nature. OCC Interpretive Letter No. 781 (April 9, 1997).

Federal Register/Volume. 77, No. 114/Wednesday, June 13, 2012 pages 35253 to 35263:
Part 1 - Investment Securities: Section 1.2

(1) (d) Investment grade means the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An Issuer has an adequate capacity to meet financial commitments if the risk of default is high and the full and timely repayment of the principal and interest is expected.
(e) Investment security means a marketable debt obligation that is investment grade and not predominantly speculative in nature.

(2) (f) Marketable means that the security: (1) is registered under the Securities Act of 1933; (2) is a municipal revenue bond exempt from registration; (3) is offered and sold pursuant to SEC Rule 144A and and investment grade; or (4) can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

(3) 12 CFR Section 1.2: Capital and Surplus means for qualifying community banking organizations that have elected to use the CBLR framework: tier 1 capital plus allowance for loan and lease losses or adjusted allowance for credit losses as applicable. For all other banks: tier 1 and tier 2 capital calculated under the OCC's risk based capital standards plus the balance of a bank's allowance for loan and lease losses or adjusted allowances for credit losses as applicable not included in the bank's tier 2 capital for purposes of the bank's calculation of risk-based capital.

(4) While technically possible to underwrite preferred stock investments as a loan, guidance from senior OCC regulatory staff suggests that this is likely not feasable and such investments would be more likely underwritten under investment policy.

Sources: Code of Financial Regulation (CFR), U.S. Code (USC), Federal Register, and OCC interpretive letters as specifically cited in the chart.

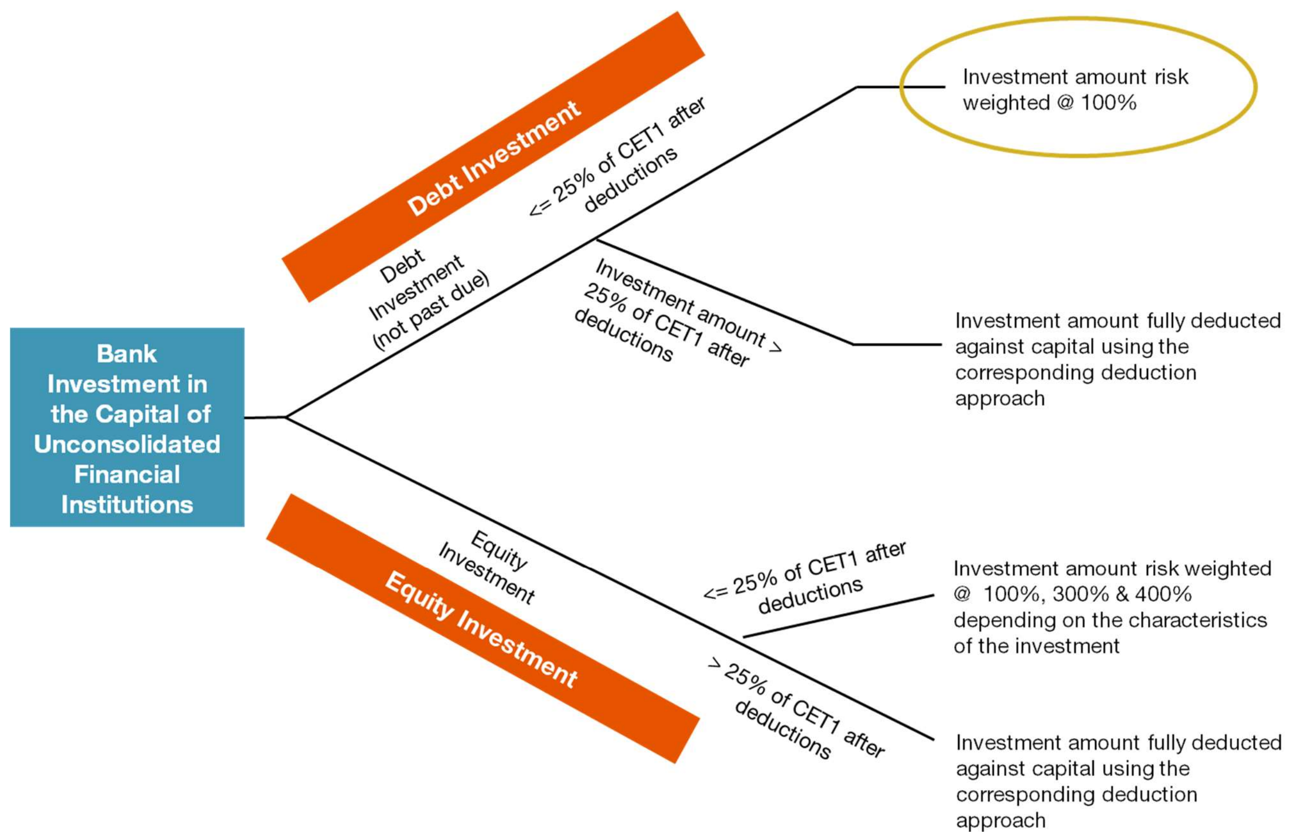
Chart D describes investment authorities for national banks. Federal savings institutions (FSAs) have very different investment authorities. FSAs do not have general lending authority to underwrite UFI investments as loans. Section 12 CFR 160.40 provides authority to invest in investment grade and marketable corporate debt but the OTS and OCC have not concluded that anything other than publicly registered securities are considered marketable. As such, any FSAs that intend to hold significant investments in anything other than publicly registered securities may want to pursue an interpretive letter from the OCC to support such investments.

Aggregate Investment Limits for NAABs

With a clear understanding of what types of securities are permitted to be incrementally purchased, let's now turn to the aggregate investment limits from the Basel III Simplication Final Rule applicable to NAABs. For bank-level investments, while the total investments in any one issuer cannot exceed 10% of capital and surplus, this does not mean that the bank is limited to the combined amount of Type II and III securities it holds from multiple obligors. For example, it is possible that a bank could hold Type III securities issued by multiple obligors with a combined aggregate par value exceeding 10% of capital and surplus. Note that there is a distinction between the OCC guidance based on capital and surplus and the Basel III Simplification's Final Rule aggregate investment limits based on CET1.

As illustrated in Chart E below, debt investments in UFIs below the 25% of CET1 aggregate limit will be risk weighted at 100%. Note that this 25% of CET1 is an aggregate limit, combining both debt and equity investments at the bank and BHC level.

Chart E: Basel III Decision Framework AFTER Basel III Simplification* (Q1 2020) Applicable to Non-Advanced Approaches Banking Organizations



Source: Basel III Simplification Final Rule for Non-advanced Approaches Banks

* ***The aggregate limit on investments in UFIs whether debt or equity is 25% of CET1. Investments in excess of that amount would be deducted against capital using the corresponding deduction approach. Chart E assumes that preferred equity is debt-equivalent equity evaluated the same as sub-debt at the top branch of the decision tree. All other equity investments would be evaluated through the bottom branch of the decision tree.***

As noted above, debt investments in UFIs greater than 25% of adjusted CET1 will be deducted against bank capital using the corresponding deduction approach. The treatment of equity investments in UFIs is addressed below.

Permitted Investment in Equities

With regard to bank-level investment in equities, the OCC has determined that national banks may purchase preferred stock as an investment security where the preferred stock can properly be characterized, in substance, as a debt obligation. As shown below in Chart F, some factors that support that characterization include the following:

Chart F: Debt-Equivalent Factors for Preferred Stock

- Preferred stockholders do not share in the profits of the issuer;
- Preferred stockholders do not have the authority to vote on ownership matters other than in limited situations;
- Claims of common stockholders are subordinate to the holders of preferred stock upon dissolution of the company;
- Preferred stock is also given a credit rating by rating agencies; and
- Preferred stock may have a stated final maturity but the OCC has also approved investment in money market preferred stock with a perpetual maturity.

The investing bank must have conducted an independent analysis to determine that the acquisition of the preferred stock meets the bank's internal standards and must maintain its analysis on a continuing and ongoing basis as long as it owns the preferred stock.

In recent discussions with senior regulatory staff, we clarified that under the Basel III Simplification Final Rule, investments in non-cumulative perpetual preferred stock issued by UFIs may be evaluated the same as subordinated debt investments with an aggregate limitation of 25% of adjusted CET1 and risk-weighting at 100%. Due to the fixed income nature of the instrument, senior regulatory staff view non-cumulative perpetual preferred as being the same as debt for purposes of the application of the Basel III simplification. Please note that any preferred stock must still qualify as a permissible investment under the OCC requirements for investment grade equivalent and marketability qualifications and preferred stock is still treated as an equity investment for GAAP purposes and would be subject to the accounting treatment appropriate for such equity investments.

As a practical matter, investments in UFI common or convertible equity will likely not be permitted investments at the bank level since they would generally not meet the fixed income equivalent criteria discussed earlier. All other equity investments that are not viewed as fixed income equivalents would fit in the bottom branch of the decision tree in Chart E above. (Excluding BOLI and certain other exposures to equity securities expressly permitted by statute) These investments must be considered at the BHC level. Equity UFI amounts less than 10% of total capital would be risk-weighted at 100% while equity investments greater than or equal to 10% of total capital and less than 25% of adjusted CET1 would be risk-weighted depending on the type of investment from 300% for publicly traded equity exposures, 400% for equity exposures not publicly traded, or 600% for equity exposure to an investment firm.

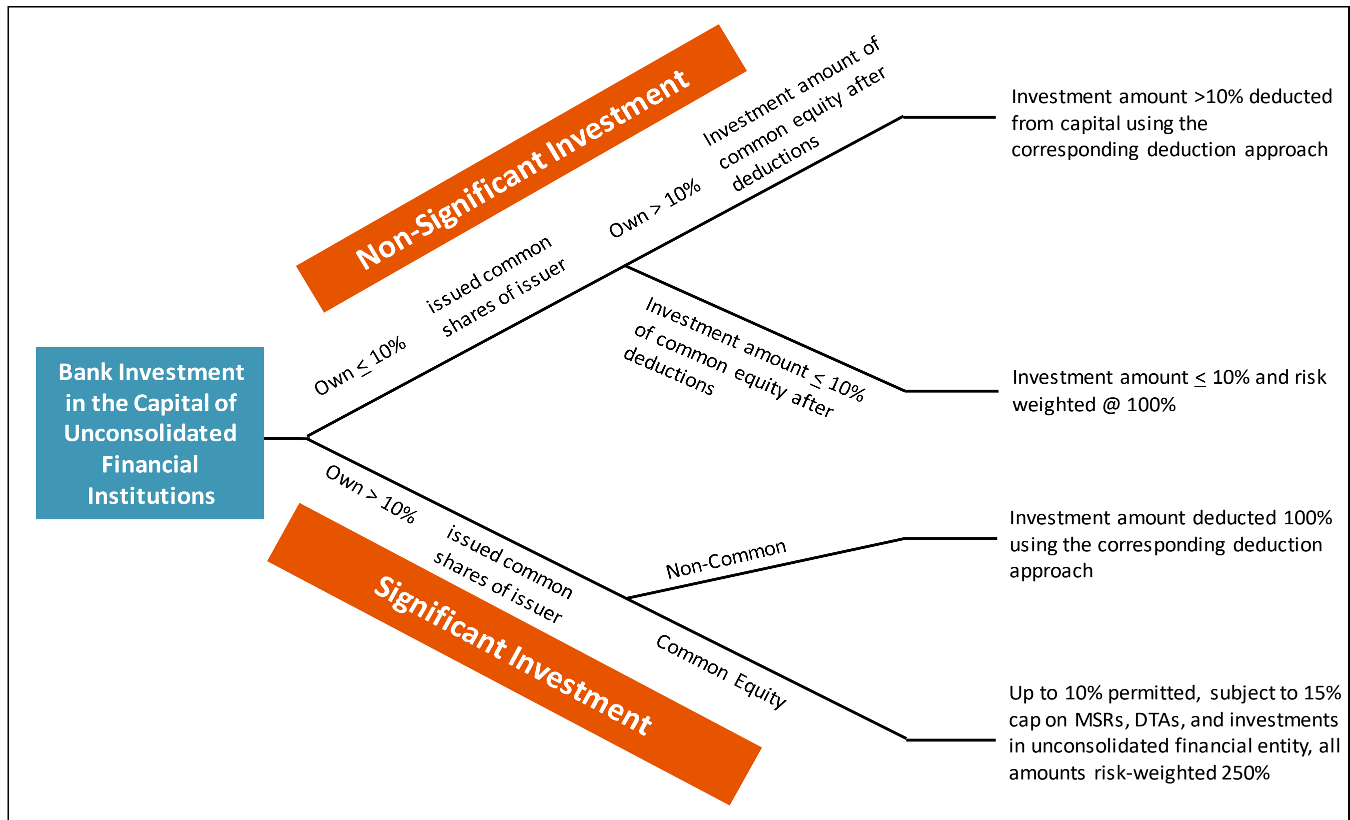
Bank holding companies (BHCs) may invest in voting and non-voting equity securities of other banks or BHCs subject to determination of control under the Bank Holding Company Act (BHC Act) or the Home Owners Loan Act (HOLA). If the investing BHC is deemed to control the target company, the BHC could be subject to

restrictions on activity, source of strength requirements, capital and liquidity requirements, regulatory reporting, transactions with affiliates rules, and ongoing supervision by the Federal Reserve Board. The acquisition by a BHC or SLHC of direct or indirect ownership or control of more than 5 percent of the outstanding shares of any class of voting securities of a bank or bank holding company requires prior approval. The Federal Reserve also recently updated its control rules in Regulation Y and Regulation LL effective September 30, 2020 to codify its other presumptions of control. There are numerous complications to the determination of control for an equity investment that are beyond the scope of this report. For more details see ***Appendix A***.

Aggregate Investment Limits for Advanced Approaches Banks

The Basel III Simplification Final Rule does not provide Advanced Approaches Banking Organization with the same flexibility as NAABs. As highlighted below in Chart G, the Advanced Approaches Banks must comply with the original Basel III limits to determine if: (i) the UFI investment was significant or non-significant and (ii) the investment amount was greater than 10% of CET1, and then apply the corresponding deduction approach to deduct any amounts greater than 10% of CET1 from the banking organization's regulatory capital. Note that for non-significant investments where the investment amount was 10% or less of the bank's CET1, the risk weighting would be 100%. For significant investments, non-common investments are deducted 100% using the corresponding deduction approach while equity investments of up to 10% of CET1 are permitted with a risk-weighting of 250%.

Chart G: Basel III Decision Framework Applicable to Advanced Approaches Banking Organizations



Source: Basel III Rules Applicable for Advanced Approaches Banks

Summary

For non-advanced approaches banking organizations, the Basel III Simplification Final Rule significantly increased the common equity tier 1 (CET1) capital threshold deductions from 10% to 25% for the amount of investment that NAABs can hold in the debt and equity capital of UFIs. Overall, the Basel III Simplification Final Rules and Regulation Y and LL updates provide clarity for banking organizations to increase their debt and equity investment in UFIs while conforming to existing OCC standards for permissibility and avoiding triggering a presumption of control for equity investments. With the current low interest rate environment, bank holding companies, savings and loan holding companies, and their depository institution subsidiaries are considering strategies to enhance net interest income through debt and equity investments in unconsolidated financial institutions (UFIs).

As summarized below in Chart H, there are a myriad of ways that banks or BHCs can invest in UFIs at the bank level or the BHC level but current accounting rules (ASC 320) require that such investments be accounted for as either debt or equity securities. Sub-debt and trust preferred would be accounted for as debt securities while fixed income-equivalent preferred stock would be accounted for as an equity security but underwritten as a debt equivalent investment under debt investment policy. It is likely not feasible for a bank to underwrite fixed-income equivalent preferred stock under its loan policy and lending authority as noted in the chart below.

Chart H – Summary Investment Grid

NAAB Summary Investment Grid *

UFI Investment Type	Investment Entity	Underwriting Type	Marketability	GAAP Accounting (ASC 320)	Investment Limits: Single Issuer	Investment Limits: Cumulative Investment
Sub Debt	Bank	Loan Policy	Low	Debt Security	Loan Policy and Lending Limits	Loan Policy, Lending Limits, 25% of CET1
	Bank	Debt Invest. Policy	Medium/High	Debt Security	10% Capital & Surplus	Debt Invest. Policy and 25% CET1
	BHC	Debt Invest. Policy	Medium/High	Debt Security	Liquidity & Source of Strength	Liquidity, Source of Strength, & Cumulative 25% of CET1 Limit
Trust Preferred	Bank	Loan Policy	Low	Debt Security	Loan Policy and Lending Limits	Loan Policy, Lending Limits, 25% of CET1
	Bank	Debt Invest. Policy	Medium/High	Debt Security	10% Capital & Surplus	Debt Inv. Policy and 25% of CET1
	BHC	Debt Invest. Policy	Medium/High	Debt Security	Liquidity & Source of Strength	Liquidity, Source of Strength, & Cumulative 25% of CET1 Limit
Preferred Stock (fixed income equivalent)	Bank	Loan Policy (**)	N/A	N/A	N/A	N/A
	Bank	Debt Invest. Policy	Medium/High	Equity Security	10% Capital & Surplus	Debt Invest. Policy and 25% CET1
	BHC	Debt Invest. Policy	Medium/High	Equity Security	Liquidity, Source of Strength & Control Rules	Liquidity, Source of Strength, Control Rules, & Cum. 25% of CET1 Limit
Common Equity	BHC	Equity Invest. Policy	Medium/High	Equity Security	Liquidity, Source of Strength & Control Rules	Liquidity, Source of Strength, Control Rules, & Cum. 25% of CET1 Limit

* Grid represents a high level summary and should be read in conjunction with the more detailed explanations provided in the complete report. Whether underwritten as a loan or a security, NAABs are limited to cumulative investment in UFIs of 25% or less of CET1 to avoid capital deductions.
**While technically possible to underwrite preferred stock investment as a loan, guidance from senior OCC regulatory staff suggests that this is likely not feasable.

Sources: Code of Financial Regulation (CFR), U.S. Code (USC), Federal Register, and OCC Interpretive Letters specifically cited in Chart D herein, and the OCC Bank Accounting Advisory Series.

NAABs can underwrite UFI investments either as loans or investment securities. Investments that are determined to be investment grade equivalent in quality and marketable can be purchased as securities and would be subject to the bank's investment policy and limits. Investments that are not determined to be marketable would have to be underwritten as loans under the bank's lending authority to "buy and negotiate debt" and would be subject to the bank's loan underwriting policy and legal lending limits. (Please Appendix B for a Summary of Risk Management Practices for Loan Purchase Activity) While banks can receive assistance with analyzing investments in UFIs from third party advisors, such relationships are subject to the OCC's Third-Party Risk Management Guidance in Bulletin 2013-29 (along with subsequent FAQs) which specify requirements to avoid conflicts of interest and other considerations.

UFI investments originally acquired and booked as securities would remain classified as securities. If subsequent experience led the buyer to believe that the security did not conform with the marketability requirements, it would either need to be brought into conformity with documentation of liquidity or it would be considered non-

conforming. While a limited amount of non-conforming investments may be maintained in the securities portfolio, any significant amounts would either need to be brought into conformity with documentation of liquidity or a plan would need to be developed to either sell the security or have it re-underwritten under the bank's lending authority. Please keep in mind, however, that as previously noted, FSAs do not have general lending authority to underwrite UFI investments as loans.

A strong secondary market has developed for debt and capital securities issued by banks in private placements, 144A and registered offerings such that, absent a temporary global market disruption, these securities can generally be sold at pricing that reasonably approximates fair value. Banks active in investing in such securities must document the liquidity of their investments just as they would document the evaluation of the credit. The investment amount per issuer at the bank level is limited to 10% of capital and surplus. Equity investments (other than debt-equivalent preferred stock) in UFIs would be booked at the BHC/SLHC level where the amount of voting common stock and aggregate total equity ownership including common and preferred stock are primary determinants of control. (Please see Appendix A for updated Regulation Y and LL considerations by the Federal Reserve effective September 30, 2020). Debt investments in UFIs booked at the BHC/SLHC level are not required to meet the same investment grade and marketability standards as bank level investments. However, the BHC is expected to be a source of strength for the bank and maintain adequate income and cash flow which ultimately limits the amount of non-investment grade illiquid investments that can be held at the BHC/SLHC level.

Armed with this road map for navigating what can be a complicated process on how to underwrite UFI investments, whether to book them as a loan or security, whether to book at the bank or the BHC level, how much to invest and how to support marketability, bank management teams and their boards of directors will now, hopefully, be better informed and better equipped to underwrite, buy and sell debt and equity issued by UFIs subject to the general information and disclaimers provided in the paragraph below.

This report is not intended to and does not provide a recommendation with respect to any security. This report does not take into account the financial position or particular needs or investment objectives of any individual or entity. The investment strategies, if any, discussed in this report may not be suitable for all investors. Investors must make their own determinations of the appropriateness of an investment strategy and an investment in any particular securities based upon the legal, tax and accounting considerations applicable to such investors and their own investment objective.

Appendix A

Summary of Tiered Presumptions

(Presumption triggered if any relationship exceeds the amount on the table)

	Less than 5% voting	5-9.99% voting	10-14.99% voting	15-24.99% voting
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company	A quarter or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of revenues or expenses of the second company	Less than 5% of revenues or expenses of the second company	Less than 2% of revenues or expenses of the second company
Business Terms	Business Terms	Business Terms	Business Terms	Business Terms
Officer/Employee Interlocks	N/A	No more than 1 interlock , never CEO	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity	BHCs - Less than 1/3 SLHCs - 25% or less	BHCs - Less than 1/3 SLHCs - 25% or less	BHCs - Less than 1/3 SLHCs - 25% or less	BHCs - Less than 1/3 SLHCs - 25% or less

Source: Federal Reserve System. 12 CFR Parts 225 and 238. Regulations Y and LL; Docket No R-1662. April 1, 2020.

Appendix B

Summary of Risk Management Practices for Loan Purchase Activity

Lending Policies and Procedures:

- Approval limits and personnel authorized to engage in loan purchases
- Acceptable credit types and portfolio characteristics
- Acceptable sources from which to purchase loans, including standards for selecting sellers and concentration limits for seller volume
- Requirements for purchase agreements, including rights and obligations concerning repurchase and recourse arrangements
- Expectations regarding the level of due diligence to be performed in assessing the potential purchase of loans, including standards for:
    - Pre-purchase documentation
    - Independent credit and underwriting analysis
    - Determining the collateral value and confirming the lien status
- Requirements for obtaining ongoing financial and nonfinancial information for the term of the loan.
- Credit administration requirements, including post-purchase management, risk rating, credit scoring, loan loss allowance, and problem loan management

Due Diligence and Independent Credit Analysis Includes:

- Credit analysis independent of the seller that includes assessing whether the loan(s) meet the bank's underwriting standards and other loan policy criteria
- Assessing the quality of the collateral and the appropriateness of collateral valuation methods
- Analyzing the purchasing bank's history with the seller and the seller's experience with the lending product and financial capacity
- Risk assessment of all applicable risks
- Thorough assessment and legal review of the purchase contract, including recourse and risk-sharing arrangements, loan administration and collateral controls
- Assessing accounting implications, such as sales treatment and loan loss allowance

Required Documentation:

- Credit agreement
- Underwriting documentation
- Borrower supplied documents used during underwriting and ongoing monitoring including financial statements
- Collateral description and values, and documentation supporting asset valuation methods
- Security agreements, lien or mortgage status, and supporting documents
- Status of principal and interest payments including accrual status
- Any other facts bearing on the continuing creditworthiness of the borrower

For more complete information on sound risk management practices for loan purchase activities please refer to (OCC Bulletin 2020-81, September 10, 2020).

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