

RESCINDED

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Office of Thrift Supervision
Department of the Treasury

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MEMORANDUM FOR CHIEF EXECUTIVE OFFICERS

FROM: Richard M. Riccobono 

SUBJECT: Underwriting the Purchase of Investment Securities

There have been instances where savings associations have purchased investment securities without performing thorough underwriting analyses. The purpose of this memorandum is to remind savings associations of their responsibility to perform a thorough analysis of the quality of any security in which they invest. Prior to committing to purchase any investment security, management must first determine that an investment meets applicable regulatory and policy requirements, including:

- 12 CFR 560.40, Commercial Paper and Corporate Debt Securities
- 12 CFR 560.32, Pass-Through Investments
- TB 13a, Management of Interest Rate Risk, Investment Securities and Derivative Activities

If the investment meets those requirements, management should then determine if the investment is suitable for the institution and is safe and sound. Management should:

- 1) Determine that the issuer, together with any guarantors, has the financial capacity, and willingness to meet the repayment terms of the investment.
- 2) Analyze the legal structure of the investment to determine that the institution has the authority to make such an investment.
- 3) Analyze the expected performance of the issuer and any underlying assets. This should include a cash flow analysis prepared by the institution or a party engaged by the institution other than the seller/broker. The analysis must include expected performance under various loss and interest rate scenarios, its expected affect on the overall interest risk profile of the institution, and must consider all covenants of any trust agreement that apply to the senior tranches.
- 4) Analyze the entire security. If the security is divided into separate tranches with unequal payments, the analysis must include the effect of the payment priority on the investment purchased.
- 5) Review and analyze the collateral managers, including their historical performance in managing such funds and their ability to make prudent investments, both when the fund is started and during any revolving period.

In addition to the initial underwriting of the investment, management has an ongoing responsibility to monitor the investment, including cash flows, collateral quality, and the performance of the underlying assets of the security at least quarterly to determine the effect of any changes to the institution's investment. Management should fully document all of the above analyses.

The responsibility of management to perform a thorough analysis of a particular security increases proportionately with the complexity of the security and as the rating of the security moves down the rating scale. Institutions should determine the quality and long-term suitability of investments, especially

with respect to complex securities with lower investment grades (for example, Moody's BBB) or securities that have received different ratings from different agencies. An institution's sole reliance on outside ratings for material purchases of lower investment grade securities is an unsafe and unsound practice. An institution should only use ratings and the accompanying analyses performed by nationally recognized rating agencies in conjunction with, and in validation of, its own underwriting processes; however, it may not use ratings as a substitute for proper underwriting.

The need to properly assess investment securities before committing to purchase them relates to securities with nonstandard ratings or payment features such as residual securities. For example, some investment-banking firms are marketing a new investment product sold under names such as "principal-protected trust certificates" or "split-rated trust certificates," referred to in this memorandum as "certificates." The performance of these certificates is based on the performance of part of a pool of related assets referred to as collateralized loan obligations (CLOs). CLOs are securities primarily collateralized by commercial loans of varying quality. Some issues may also be collateralized in part by high yield corporate debt securities.

CLOs are generally sold in several progressively risky tranches. The first tranche often has a high investment rating, such as AAA, due to its payment priority and the initial over collateralization of the security. The collateral also sequentially supports the next tranche(es). CLOs typically have a revolving period and an amortization period. During the revolving period, principal payments are reinvested in other assets in accordance with the terms of the agreement. During the amortization period, any principal payments are used to first repay the Class A note holders in full, then any remaining principal is used to pay junior tranche investors in order of their priority.

The middle tranches are often rated at lower investment grade ratings, such as BBB. The lowest priority tranche, or the residual interest tranche, is generally not rated. It is typically subordinated not only to senior tranches, but also to expenses of the issuing trust. These residual tranches are typically difficult to value and are illiquid investments by themselves. To make the residual tranche more marketable, the CLO issuer or trustee may swap the residual interest tranche for certificates guaranteed by a AAA-rated counterparty as to the principal amount at maturity (generally up to 12 years).

While the swap creates a guarantee of the full principal at maturity, the amount guaranteed must be discounted to its present value if terminated early. In that respect, the guaranteed portion of the security is similar to a zero-coupon Treasury bond. Therefore, the credit support provided by the guarantor may cover less than 50% of the face amount of the certificate at purchase. Unlike zero-coupon bonds, however, these certificates are generally sold at par. Investors must rely on the performance of the reference asset (the residual tranche in this case) to return the remaining portion of their investment and provide any yield. The performance of the reference asset is not, however, guaranteed. Therefore, these investments are not, and should not be considered, fully rated.

Apparently, the motivation to purchase such certificates is the high yield projected if the CLO collateral pool (and thereby the reference asset) performs well. However, there is no guarantee of residual cash flows, and the certificates will not be in default if no cash flows are paid to the investors. These investments are speculative, and are clearly not intended to hedge interest rate risk or credit risk. Based on discussions with ratings agencies, and the lack of supporting cash flow analysis, it is difficult to assess the likelihood that a particular return could be achieved on these investments. In essence, an institution should not be misled by split ratings where only a part of the security is either guaranteed or rated investment grade.

Given our concerns with these certificates, this memorandum reiterates OTS's underwriting requirements for all investment securities. When a thrift makes an investment that does not meet the regulatory requirements, its investment practices will be subject to criticism and OTS may require divestiture of such securities. In addition, securities must be appropriate for the institution and must be properly underwritten to be considered safe and sound investments.