



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 3, 2005

Interpretive Letter #1027
May 2005
12 USC 24(7)

Subject: Acquisition of Preferred Securities

Dear []:

[], (“Bank”) is seeking confirmation from the Office of the Comptroller of the Currency (“OCC”) that it is permissible for the Bank to purchase and hold for its own account, the preferred securities of two special purpose entities that principally hold interests in Australian mortgage loans. Based on the information you have provided, and for the reasons discussed below, we conclude that the Bank may purchase and hold the preferred securities.

Background

The Bank represents that its purchases of the preferred securities will facilitate the Bank’s plans to raise its profile as a provider of funding in the Australian mortgage market. The Australian mortgage market is attractive to the Bank because of the large supply of Australian residential mortgages.

Underlying Assets

The Bank seeks to purchase interests in a pool of Australian residential mortgages (“Mortgage Assets”) originally held by an unaffiliated Australian financial institution (“Sponsor”). The Sponsor intends to deposit the Mortgage Assets into a bankruptcy remote securitization vehicle (“Trust”). The Trust will issue several classes of residential mortgage backed securities (collectively, the “RMBS”). The RMBS will consist of a senior note (“Senior Note”) and a junior note (“Junior Note”) (collectively, the “Notes”) and an excess income unit (“Income Unit”) issued by the Trust.¹ The Notes will be senior secured notes that are backed by the

¹ The Income Unit pays the excess margin between the income generated by the Mortgage Assets and the expense associated with the Notes issued by the Trust.

Mortgage Assets. The Income Unit will entitle the holder to the excess income of the Trust, if any.

Special Purpose Entities

Two special purpose entities organized under Australian law (“[**AB**]” and “[**CD**],” collectively “SPEs”) will acquire all of the assets of the Trust.² Then, the SPEs will issue securities representing interests in the Mortgage Assets, some of which the Bank proposes to acquire.

[**CD**]’s only asset will be the Senior Note. [**CD**] will issue mandatory converting preferred shares (“[**CD**] Preferred”) and a small amount of common stock.³

[**AB**]’s assets will include: (i) all [**CD**] Preferred (other than a nominal amount directly held by the Bank), (ii) all common stock issued by [**CD**], (iii) the Junior Note issued by the Trust, and (iv) the Income Unit issued by the Trust. [**AB**] will also have a minimum of \$25 million in excess cash that it will invest in high quality short-term debt instruments. [**AB Co.**] will issue a Class A1 Note, a Class B Converting Note, Class C, D1, D2 and E Preferred Shares, and Class F Common Shares. [**AB.**]’s Class D1 and D2 Preferred Shares will rank senior to the Class E and Class F shares but subordinate to the Class A note, Class B Converting Note and Class C Shares. The Class E and Class F shares provide combined first loss protection up to \$40.6MM.

The Bank will purchase a nominal amount of [**CD**] Preferred and the Class D-1 and Class D-2 Preferred Shares⁴ issued by [**AB**] (“[**AB**] Preferred”) (the [**CD**] Preferred and [**AB**] Preferred will be collectively be referred to herein as the “Preferred”).

Holders of the [**CD**] Preferred vote together as a single class for the election of all directors of [**CD**]. Because the Bank's direct ownership of the [**CD**] Preferred represents approximately .0013% of the total voting rights of [**CD**] and shareholder votes are decided on a majority basis, the Bank will not be able to elect a director or exert any control over [**CD**]. [**AB**] will have control over [**CD**] through its majority voting rights in the [**CD**] Preferred.

² [**CD**] and [**AB**] are exempt from registration under the Investment Company Act of 1940 (’40 Act). Section 3(c)(1) of the ’40 Act exempts an entity from registration if it will have fewer than 100 investors. [**CD**] and [**AB**] both will have fewer than 100 investors and are therefore exempt under this provision. In addition, [**AB**] and [**CD**] may offer their securities through nonpublic offerings to sophisticated investors pursuant to another exemption from registration under the ’40 Act. Section 3(c)(7) of the ’40 Act.

³ The [**CD**] Preferred will convert to equity at the expiration of ten years. Simultaneous with the conversion, the Bank will exercise its right to sell the securities to [**AB**] under the terms of a put option.

⁴ The economic rights of the Class D-1 and D-2 Preferred shares are identical; however, the voting rights of the overall Class D Preferred will be allocated between them disproportionately. Thus, the Bank can elect to sell one class of these shares to third parties, while retaining the other.

The [**AB**] Preferred will be freely transferable and have a fixed term for mandatory redemption⁵ subject to certain rights for early termination and redemption. The [**AB**] Preferred provides for fixed, cumulative dividends.

Holders of the [**AB**] Preferred will have 22% of the voting rights of [**AB**].⁶ [**AB**] Preferred shareholders will be entitled to appoint one director to [**AB**]'s board. [**AB**] will have a total of five directors. The remaining four directors will be appointed by the holders of other classes of [**AB**] preferred stock (all unaffiliated with the Bank) and will be subject to a shareholder agreement that states that the remaining directors shall vote together on all matters. Because the organizational documents will require a majority vote on all matters, the [**AB**] Preferred director in effect has no control or operational power over [**AB**]. The [**AB**] Preferred director will have contingent super-voting rights if certain triggering events potentially lead to early termination and redemption.

Ratings

The Preferred will not be rated; however, the Bank believes that each will be the credit equivalent of a security rated investment grade based on the ratings and credit equivalence of the SPEs' underlying assets.

Exit Rights

In the event that the Bank decides to redeem the Preferred prior to the scheduled maturity date, the Bank may do so in one of two ways. The Bank may sell the Preferred to a third party or, under certain circumstances, cause [**AB**] and [**CD**] to liquidate their underlying assets, dissolve [**AB**] and [**CD**], and distribute the proceeds to the Bank and the other investors.⁷

Discussion

The Bank may purchase the Preferred as participation interests in pooled loans under its general lending authority. A national bank's "general lending authority" is derived from 12 U.S.C. § 24(Seventh)'s express authorization to national banks to conduct the business of banking by "discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt" and "loaning money on personal security." The OCC has previously concluded that national banks may purchase participation interests in pooled loans under their general lending authority.⁸ For example, the OCC has approved a national bank's purchase of participation

⁵ The fixed term is anticipated to be 10 years.

⁶ Class D-1 shares will hold 5% of the voting rights, while Class D-2 shares will hold 17% of the voting rights.

⁷ To pursue any or all of these strategies, the Bank will take advantage of super-voting rights, provided by the [**AB**] Preferred.

⁸ See, e.g., OCC Interpretive Letter No. 579 (March 24, 1992); OCC Interpretive Letter No. 25 (February 14, 1978); OCC Interpretive Letter No. 41 (May 18, 1978).

certificates representing interests in pools of FHA-insured Title I property improvement loans as a use of its general lending authority.⁹ The fact that here the Bank's interest in the Mortgage Assets is evidenced by the Preferred does not change the fact that the Bank will indirectly be holding interests in the underlying loans.

The Bank must adhere to the prudential requirements in Banking Circular 181 (Rev.) and OCC Bulletin 2002-19¹⁰ when acquiring the Preferred. The Bank must satisfy itself, based on an independent credit analysis, that the Preferred is an appropriate investment for the Bank. The nature and extent of the Bank's independent credit assessment is a function of the type of transactions at issue and the Bank's lending policies and procedures. The Bank's acceptance of a favorable analysis of the Preferred by the SPE issuers, a credit rating institution, or another entity does not satisfy the need to conduct an independent credit analysis. The Bank may, however, consider an analysis by other sources as a factor when independently assessing the Preferred. The Bank must maintain its analysis on an ongoing basis and must have continued access to appropriate credit and portfolio performance data as long as it holds the Preferred.¹¹ The analysis conducted at the time of acquisition should be maintained as part of a national bank's fully documented loan files.¹²

The Bank's acquisition of the Preferred is subject to the lending limit restrictions of 12 U.S.C. § 84. Thus, the Bank may not purchase the Preferred from [**CD**] or [**AB**] in an amount that, when combined with all other loans to, or acquisitions made on the basis of the Bank's lending authority from, either of these issuers exceeds 15% of the bank's capital and surplus.¹³ In this case, the Preferred acquisitions represent approximately 1% of the Bank's capital and surplus. This amount is within the prudential limits of 12 U.S.C. § 84, provided the Bank has no other loans outstanding to, or acquisitions made on the basis of the Bank's lending authority from, [**CD**] or [**AB**].

The Preferred described herein, arise from a structured finance transaction that is very complex and as such, are only appropriate in a well-diversified portfolio at institutions that have sophisticated risk management processes to conduct the necessary due diligence and ongoing monitoring of risk exposures. While the Bank may acquire the Preferred under its general lending authority, it may do so only if the activity can be conducted in a safe and sound manner. Accordingly, the Bank's risk management process must reflect that the proposed activities are conducted safely and soundly. An effective risk management process includes appropriate

⁹ OCC Interpretive Letter No. 579, *supra*.

¹⁰ Banking Circular 181, Rev. (August 2, 1984) ("BC-181"), OCC Bulletin 2002-19, (May 22, 2002) ("OCC 2002-19").

¹¹ *See e.g.*, OCC Interpretive Letter No. 941 (June 11, 2002); OCC Interpretive Letter No. 908 (April 23, 2001); OCC Interpretive Letter No. 600 (July 31, 1992).

¹² *See, e.g.*, OCC Interpretive Letter No. 941, *supra*; OCC Interpretive Letter No. 930 (March 11, 2002); OCC Interpretive Letter No. 908, *supra*.

¹³ OCC Interpretive Letter No. 579, *supra*.

oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, management information systems and an effective and independent risk control function that oversees and ensures the appropriateness of the risk management process.¹⁴

Conclusion

The Bank has the authority to acquire the Preferred under its general lending authority if the acquisition is consistent with BC-181 and OCC 2002-19, within the applicable limits of 12 U.S.C. § 84, and safe and sound. This authorization is limited to the Bank and the particular investment addressed herein.

If you have any questions, please contact Tena M. Alexander, Special Counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

signed

Daniel P. Stipano
Acting Chief Counsel

¹⁴ See e.g., OCC Bulletin 2004-20, *Risk Management of New, Expanded, or Modified Bank Products and Services* (May 10, 2004); *Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities*, 69 Fed. Reg. 28980 (May 19, 2004) (proposed guidance).