

INTERPRETIVE LETTER 94-024 (NOVEMBER 1, 1994)

State bank may purchase and hold non-rated marketable investment securities under the authority of Section 5(11), subject to the standards and limitations applicable to a national bank for the type of investment, notwithstanding the limitations in Section 33.

We are writing in response to your letters to the Illinois Commissioner of Banks and Trust Companies. Your letters responded to our requests for * and * (ABanks@) to provide us with the authority upon which Banks are relying to invest in non-rated out of state revenue bonds. We conclude that the Banks may invest in such bonds subject to the following limitations.

You informed us that * Bank owns three non-rated out of state revenue bonds totaling \$*, and in your later correspondence, that the investment was now \$*, by virtue of a purchase and sale between the Banks. * Bank owns five non-rated out of state revenue bonds totaling \$*. We requested that the Banks provide us with the authority relied upon to invest in such bonds because the FDIC cited Banks for violations of Section 33 of the Illinois Banking Act (AAct@), which requires out of state revenue bonds to be rated in the top four rating categories by a national rating service.

The issue is whether an Illinois state-chartered bank may purchase for its own account marketable investment securities pursuant to Section 5(11) of the Act, even if such purchase would violate Section 33 of the Act.

Section 33 sets forth the applicable limitations on a state bank's investments in marketable investment securities.

Sec. 33. Marketable investment securities limit. Any State bank may purchase for its own account marketable investment securities....Marketable investment securities shall be rated in the top 4 rating categories by national rating services and designated as Ainvestment grade@ or Abank quality investments@ securities. The rating restriction on marketable investment securities does not apply to securities that are issued by a public agency as defined in Section 1 of the Public Funds Investment Act [30 ILCS 235/1].

Sections 34 and 35 of the Act provide certain exceptions to the limits in Section 33, but non-rated out of state revenue bonds are not covered under any such exceptions; therefore, notwithstanding Section 5(11), such bonds must be rated as required by Section 33 or a state bank lacks the authority to invest in them.

However, Section 5(11) of the Act authorizes a state bank to do any act that a national bank may do.

Sec. 5. General corporate powers. A bank organized under this Act...shall... have...the following additional general corporate powers:

(11) Notwithstanding any other provisions of this Act, to do any act and to own, possess, and carry as assets property of the character, including stock, that at the time is authorized or permitted to national banks by an Act of Congress, but subject always to the same limitations and restrictions as are applicable to national banks by the pertinent federal law.

The Office of the Comptroller of the Currency (AOCC) promulgated a regulation to govern the purchase, sale, dealing in, underwriting, and holding of investment securities by national banks... 12 C.F.R. ' 1.2 (1993). An investment security is defined as: A[a] marketable obligation in the form of a bond, note, or debenture which is commonly regarded as an investment security. It does not include investments which are predominantly speculative in nature. 12 C.F.R. ' 1.3 (1993).

Investment securities are further subdivided into three types of securities. A Type I securities, which may be purchased or held without limitation, include A obligations of the United States, general obligations of any State of the United States or any political subdivision thereof and other obligations listed in paragraph Seventh of 12 U.S.C. 24.

12 C.F.R. ' 1.3(c) (1993). A Type II securities are those that a national bank A may deal in, underwrite, purchase, and sell for its own account, subject to a 10-percent [of capital and surplus] limitation. Type II securities generally consist of obligations issued by governmental and quasi-governmental entities. 12 C.F.R. ' 1.3(d) (1993). A A Type III security (all other types of debt securities) A means a security which a bank may purchase and sell for its own account, subject to a 10-percent limitation, but may neither deal in nor underwrite. 12 C.F.R. ' 1.3(e) (1993).

A national bank that invests in Type II and Type III securities must make a prudent banking judgment, based on adequate evidence, that the obligor that issued the security will be able to perform all its obligations in connection with the security, including all debt service requirements, and that the security is marketable, *i.e.*, that the security may be sold with reasonable promptness at a price which corresponds reasonably to its fair market value. 12 C.F.R. ' 1.5(a) (1993). This prudent banking judgment may be based in part upon estimates that the bank believes are reliable, provided that purchases of securities based predominantly upon such estimates may not exceed at any time 5 percent of the bank's capital and surplus. 12 C.F.R. ' ' 1.5(b) and 1.7(b) (1993).

We conclude that Section 5(11) is a separate source of authority, independent of Section 33, and A notwithstanding any other provision of the Act (including Section 33), permits the Banks A to own...assets of the character, including stock...that is authorized or permitted to national banks.... Section 5(11) requires that a bank conducting an activity or making an investment pursuant to Section 5(11) must comply with the limitations and conditions applicable to national banks exercising such power. National banks are not legally prohibited from purchasing, holding or trading investment securities that are not

rated in the top 4 categories or that are not investment grade. Therefore, if the Banks exercise their authority to purchase investment securities pursuant to Section 5(11), they are not bound by this rating requirement either. Instead, the Banks must exercise the prudent banking judgment and due diligence described in 12 C.F.R. § 1.5 (1993) and should be prepared to document and demonstrate that they have exercised such judgment and diligence. We require that as part of the Banks' due diligence, they obtain a prospectus, or similar document if the prospectus is unavailable, and place written evidence in the Banks' files that the prospectus or similar instrument has been reviewed.

In addition, non-rated out of state revenue bonds purchased pursuant to the authority in Section 5(11) are subject to the 10-percent of capital and surplus limitation in 12 C.F.R. § 1.3(d) (1993). For purposes of calculating the 10-percent of capital and surplus limitation, the national bank definition of capital and surplus in 12 C.F.R. § 3.100 is used and not the definition of "unimpaired capital and unimpaired surplus" in Section 2 of the Act.

The Banks may purchase for their own account marketable investment securities under the separate authority of Section 5(11) and therefore, will not be bound by the limitations on such purchases contained in Section 33. If the Banks choose to make an investment based on the authority in Section 5(11), they must exercise prudent banking judgment and due diligence as described in 12 C.F.R. §§ 1.4 and 1.5 (1993), the applicable standard for national banks, and comply with the applicable limitations on the amount of such investment that applies to a similarly situated national bank. If the Banks comply with the above, the Commissioner's Office will not assert a violation of Section 33 because of the investment.