

**STATE OF MICHIGAN
DEPARTMENT OF CONSUMER AND INDUSTRY SERVICES
OFFICE OF FINANCIAL AND INSURANCE SERVICES**

Before the Commissioner of Financial and Insurance Services

**IN THE MATTER OF: Request by
Sandra Traicoff, Howard & Howard, for
a declaratory ruling on investment by
state-chartered banks in trust preferred
securities**

Ruling No: 02-017-BT

**Issued and entered
this 8th day of May, 2002
by
Frank M. Fitzgerald
Commissioner**

**DECLARATORY RULING approving trust preferred securities for investment by
Michigan-chartered banks**

**I
BACKGROUND**

Section 63¹ of the Administrative Procedures Act of 1969 allows an agency to issue a declaratory ruling, upon request by an interested person, as to how a statute administered by the agency would be applied to an actual state of facts. Section 2101² of the Banking Code of 1999³ (Code) created a financial institutions bureau to “have jurisdiction over and administer the laws relating to financial institutions transacting business in this state” and named the commissioner of the financial institutions bureau as its head. Section 2404 of the Code authorizes the commissioner of the financial institutions bureau to “issue declaratory rulings in accordance with the administrative procedures act of 1969”. Executive Order 2000-4, effective April 3, 2000, transferred the powers of the Financial Institutions Bureau to the Office of Financial and

¹ MCL 24.263

² MCL 487.12101

³ MCL 487.11101 et seq.

Insurance Services and the powers of the Commissioner of the Financial Institutions Bureau to the Commissioner of Financial and Insurance Services.

Thus, the Commissioner of the Office of Financial and Insurance Services has authority to issue a declaratory ruling regarding the applicability of the Code to an actual state of facts. The March 14, 2002 request letter sets forth a statement of facts sufficient to enable the Commissioner to issue a declaratory ruling regarding the applicability of the Act to the stated facts.

II FACTS

Trust preferred securities have become an attractive funding vehicle for smaller bank holding companies. Trust preferred securities are non-perpetual cumulative preferred securities issued by a wholly owned trust subsidiary which uses the proceeds raised from the sale of the preferred securities to purchase a subordinated debenture issued by the parent bank holding company. The terms of the trust preferred securities and the subordinated debenture generally are identical as to term, call provisions, yield to investor, and the cumulative nature of and deferral of payments of interest/dividends.

Due to the expense of issuance of trust preferred securities via retail distribution in an underwritten public offering, some holding companies are offering such securities in private placements.

Federal regulators have granted national banks and other federally chartered depository institutions authority to purchase and hold trust preferred securities.

III ISSUE

The principal issue is whether a bank subject to the Michigan Banking Code of 1999, MCL 487.11101 et seq., may invest in trust preferred securities even if there is no ready market into which such securities may be sold.

IV ANALYSIS

The Michigan Banking Code of 1999 grants state-chartered banks authority to purchase and hold investment securities of types and to the extent permitted by the Act. Section 1202(i) of the Code defines “investment security” as:

“a marketable obligation in the form of a bond, note, or debenture, commonly regarded as an investment security and that is salable under ordinary circumstances with reasonable promptness at a fair value.” MCL 487.11202(i)

The Code requires that a bank purchasing investment securities for its own account determine not only that “there is adequate evidence that the obligor will be able to perform all it undertakes to perform in connection with the securities,” but “that the securities may be sold with reasonable promptness at a price that corresponds to their fair value.”⁴

While trust preferred securities are not specifically authorized for investment by banks under the Code, Section 4301(4)⁵ allows a bank to purchase, for its own account and within limitations, other investment securities. The total amount of investment securities of any 1 obligor or maker, held by a bank under this subsection shall not exceed at any time 25% of its capital and surplus.

The absence of a ready market, as postulated in the instant request, would prevent some trust preferred security from being “investment securities” under the Code. There are, however, no

⁴ MCL 487.14302(1)

⁵ MCL 487.14301(4)

specific limitations on bank powers under the Code or other laws of this state that would prohibit bank investment in a trust preferred security issuance. Code Section 4303 grants state-chartered banks the authority to invest in other assets authorized by order or declaratory ruling of the Commissioner.⁶

Trust preferred securities possess ample characteristics of debt instruments and are sometimes referred to as “hybrid” instruments. The credit quality of the issuing bank holding company is of primary concern to an investor in trust preferred securities. Investors in trust preferred securities do not share in any appreciation in the value of the issuer trust and, except for credit risk, are protected from changes in the value of the principal of the instruments. Holders of trust preferred securities have no voting rights in the management or business of the issuer. The distributions on trust preferred securities resemble the periodic interest payments on debt. Trust preferred securities must be redeemed when the subordinated debt is repaid, i.e., like debt, they are not perpetual. With thorough analysis and proper underwriting and monitoring, bank investment in trust preferred securities can be conducted safely and soundly.

Other depository institutions, operating pursuant to federal law and regulation and that are competitors of state banks, may invest in trust preferred securities. Federal regulatory agencies have concluded that trust preferred securities are permissible investments for banks, savings banks, and thrifts. They have taken the position that an investment in trust preferred securities is functionally equivalent to an investment in the underlying debenture. The holders of trust preferred securities receive the same distribution as they would if they held the debentures.

The FDIC describes trust preferred securities as “hybrid instruments possessing characteristics typically associated with debt obligations.”⁷ The Comptroller of the Currency stated in 2001, “Because they qualify as debt obligations, trust preferred securities may be purchased and held

⁶ “Notwithstanding any other section of this act, a bank may invest in other assets authorized by order or declaratory ruling of the commissioner.” MCL 487.14303

⁷ Federal Deposit Insurance Corporation: FIL-16-99, February 19, 1999

as loans under the authority to discount and negotiate evidences of debt.”⁸ The Comptroller’s letter subjects national bank investments in trust preferred securities to statutory lending limits based on the investor’s capital and surplus, and to application of prudential lending practices.

Section 24(a) of the Federal Deposit Insurance Act specifies that no insured state bank may engage as principal in any activity which is not permissible for a national bank, unless the bank is in compliance with applicable capital standards and the FDIC has determined that the proposed activity would not pose a significant risk to the deposit insurance fund.⁹ In a letter dated March 11, 2002, FDIC Senior Regional Attorney Christine Tullio stated, in pertinent part, “. . .if a state nonmember bank purchases trust preferred securities consistent with applicable state law and within the scope of the OCC’s written authority. . .the FDIC considers the activity permissible for state nonmember banks by virtue of section 24 of the [Federal Deposit Insurance] Act.” OCC Interpretive Letter #908, quoted in part above, is presented as providing written evidence of the permissibility of national banks to purchase and hold trust preferred securities.

V RULING

IT IS MY RULING that trust preferred securities are approved investments for state-chartered Michigan banks, as follows.

1. A trust preferred security that meets the criteria set forth in MCL 487.11202(i) shall be considered an investment security for purposes of MCL 487.14301(4) and subject to the investment limitations contained in that subsection.
2. A trust preferred security that is not readily salable at a price that reflects its fair value may be purchased as an investment in other assets pursuant to MCL 487.14303 under the following conditions:

⁸ Office of the Comptroller of the Currency: Interpretive Letter #908, April 23, 2001

⁹ 12 U.S.C. 1831(a)

a. The issuer trust shall purchase only subordinated debentures from its parent bank holding company.

b. In light of the debt characteristics of trust preferred securities, the total investment in trust preferred issuances of any one issuer shall not exceed the limitation established in Banking Code Section 4202, MCL 487.14202, on extensions of credit to a person.

c. The investing bank shall exercise due diligence, including independent analysis of the issuance, prior to purchasing trust preferred securities and shall continue to have appropriate credit and portfolio performance data as long as it holds the investment. The investing bank shall not purchase a trust preferred security that at the time of purchase is considered distinctly or predominantly speculative, or is in default, whether as to principal or interest.

An investment in trust preferred securities should be reported on the investing bank's quarterly call report in accordance with FDIC instructions.¹⁰

/ss/

Frank M. Fitzgerald
Commissioner

¹⁰ "Trust preferred securities meet the definition of a security in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Because of the mandatory redemption provision in the typical trust preferred security, investments in trust preferred securities would normally be considered debt securities for financial accounting purposes. Accordingly, regardless of the authority under which a bank is permitted to invest in trust preferred securities, banks should report these investments as debt securities for Call Report purposes (unless, based on the specific facts and circumstances of a particular issue of trust preferred securities, the securities would be considered equity rather than debt securities under Statement No. 115). If not held for trading purposes, trust preferred securities issued by U.S. business trusts should be reported in Schedule RC-B, item 6.a, "Other domestic debt securities." [from FDIC: FIL-29a-2002; Supplemental Instructions to March 31, 2002 Call Report]