TB 20 was rescinded 5/4/90. Incorporated into Thrift Activities 270

Handbook: Thrift Activities — **Section: 270**
Subjects: Qualified Thrift Investments — **TB 20**

March 10, 1989

Qualified Thrift Lender (QTL) Test

RESCINDED

Summary: This Bulletin is intended to alert Bank System staff and thrift industry employees to two Office of General Counsel ("OGC") opinions affecting the Qualified Thrift Lender ("QTL") Regulation 12 C.F.R. 583.27. The first concerns the treatment of investments in mutual funds under the QTL test. The second opinion discusses the effects of QTL failure by member institutions on Federal Home Loan Bank advances.

For Further Information Contact:
The FHLBank District in which you are located or the Policy Analysis Division of the Office of Regulatory Activities, Washington, DC.

Thrift Bulletin 20

Background

The Qualified Thrift Lender Test was designed to assure thrifts' continued focus on the "unique Congressionally defined role of providing housing-related finance." Under this regulation an institution generally must maintain 60 percent of its tangible assets in certain housing-related investments in order to retain its QTL status. The regulation specifies that the Office of Regulatory Activities will determine the eligibility of investments not specifically listed in the regulation, and that OGC will respond to specific requests requiring legal opinions. Regulatory Activities is further designated to incorporate these policy and legal determinations into a series of Thrift Bulletins. Memorandum T-87, dated January 13, 1988 was the first of these issuances.

Policy

Pursuant to the conditions set forth in attachment #1, an insured institution may count as a QTL housing-related investment all or part of its investment in an otherwise qualified "Section 545.76 . . . mutual fund", i.e., an investment company that meets the general investment requirements that are stated in Section 545.76. Furthermore, an insured *state-chartered* institution also may count some investments ("That portion of the [investment company's] assets devoted to housing related QTL investments [under] Section 587.27(1).") in investment companies that do not qualify under Section 545.76. This policy is consistent with an August 30, 1988 legal opinion issued by OGC.

The second opinion answers two questions on advances:

1. At what point will a member who fails the QTL test be required to purchase additional capital stock in order to achieve the proper ratio of capital stock to total advances: a) immediately upon failing the QTL test, or b) prior to receiving any new advance?
2. Will the advances penalty be applied to new advances, all advances or only post-CEBA advances?

As explained in more detail in attachment #2, the answer to question #1 is that the affected institution is not required to purchase additional capital stock immediately upon failing the QTL test, but, it must do so at the time it applies for new advances (at that time it must purchase stock according to the reduced availability formula). Attachment #2 answers the second question also by giving the opinion of OGC that the advances penalty applies only to "post-QTL failure" advances.

Attachments

Darrel W. Dochow

— *Darrel W. Dochow, Executive Director*

Attachment 1

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

August 30, 1988

Dear

This responds to your letter of March 29, 1988 to the Office of Regulatory Activities requesting an opinion whether investments in certain registered investment companies qualify as housing-related investments for purposes of meeting the Qualified Thrift Lender ("QTL") test, mandated by the Competitive Equality Banking Act of 1987 ("CEBA"), Pub. L. No. 100-86, 101 Stat. 552 (to be codified at 12 U.S.C. § 1730a(o)). The test was designed to assure thrifts' continued focus on the "unique Congressionally defined role of providing housing-related finance." H.R. Rep. No. 261, 100th Cong. 1st Sess. 137 (1987). Congress chose to implement this policy through CEBA by requiring an institution to maintain 60 percent of its tangible assets in certain investments deemed to be housing or housing-related investments. 12 C.F.R. § 583.27 (1988). Technically, the test requires calculation of an "actual thrift investment percentage" (the "ATIP") § 583.27(b)(1)), from a numerator consisting of the sum of an institution's and its subsidiaries' "qualified thrift investments" (§ 583.27(b)(3)), and a denominator comprised of the institution's (but not its subsidiaries') tangible assets (§ 583.27(b)(2)). The key component in calculating the ATIP is what qualifies as a housing-related investment as defined in 12 C.F.R. § 583.27(c) (1988).

You contend that investments in certain mutual funds should qualify as housing related investments as defined in section 583.27(c) for purposes of the QTL test on the following grounds:

(1) the FHLBB, in promulgating the QTL regulation, intended to include as permissible both <u>direct</u> and <u>indirect</u> investments in housing related assets;

(2) the FHLBB, in other regulations (12 C.F.R. § 545.76), has previously approved for thrift investment, mutual funds that invest in assets considered permissible thrift investments;

(3) in so doing, the FHLBB has recognized mutual funds are a conduit for investments in the underlying portfolio securities and therefore a proper form of indirect investment.

We agree with your analysis that, as a general proposition, some types of mutual funds should qualify as housing related investments. Your request appears to argue that two types of mutual funds should qualify for QTL purposes: (1) a mutual fund that invests solely in securities which constitute housing-related investments under section 583.27(c), and (2) any mutual fund that invests some of its assets in housing-related investments, but only in proportion to those assets devoted to housing-related investments. In addition, we note that there may be a third type that also needs to be addressed, namely, a mutual fund that invests solely in those investments permissible for general federal association investment pursuant to 12 C.F.R. § 545.76, but which devotes only a portion of its assets to QTL-qualified investments.

As a threshold matter, to be permissible for federal associations' general investment purposes, a mutual fund must meet existing statutory and regulatory requirements of 12 U.S.C. § 1464 (c)(1)(q) (1982 & Supp. IV 1986) ("HOLA") as implemented by 12 C.F.R. § 545.76 (1988). To be qualified under section 545.76, a mutual fund must meet the following requirements: (1) it must be an open-end management investment company registered with the SEC under the Investment Company Act of 1940; (2) its portfolio must be restricted by such management company's investment policy, changeable only if authorized by shareholder vote and (3) it must invest only in those investments that a Federal association by law or regulation may, without limitation as to percentage of assets, invest in, sell, redeem, hold or otherwise deal with. Therefore, a mutual fund that both meets the general mutual fund requirements of section 545.76 and invests only in QTL qualified investments identified in section 583.27(c) would fall squarely within the Board's existing guidelines for mutual fund investment. Consequently, the Office of General Counsel has no objection to approving such a fund for QTL purposes.

The second category to be addressed is a mutual fund the assets of which are invested solely in investments permissible pursuant to section 545.76, although not entirely in investments qualified for QTL purposes as housing related investments under section 583.27(c). Clearly, such a fund meets the basic requirements for general federal association investment purposes. Although only part of the fund is devoted to QTL qualified investments, an insured institution should be permitted to count that portion of the fund for purposes of the QTL test. This approach would not violate any Board regulations or policy and would comport with the policy goal of making the QTL test reasonably flexible. In other words, a federal association or insured institution would be able to count for QTL purposes its investment in an otherwise "section 545.76 qualified mutual fund", to the extent it invests in housing related investments as defined in section 583.27(c).

However, we must reject as inconsistent with our prior interpretations of the statutory authority to invest in mutual funds, the third category, i.e., mutual funds that are not qualified for general federal thrift investment pursuant to section 545.76 but which nevertheless devote some portion of their assets to QTL qualified investments. In the first place, this Office has never interpreted the HOLA to permit federal associations to invest in any mutual fund and simply count their investment in proportion to the fund's assets devoted to permissible thrift investments. As explained above, federal associations are limited by statute to investing in a mutual fund the investments of which are solely those deemed permissible for Federal associations (without percentage of assets limitations) by law or regulation pursuant to section 545.76(a).1/ Therefore, to permit otherwise would expand the existing authority for insured institutions to invest in mutual funds. Because a proportional inclusion approach for the broader category of general thrift investments is, in our view, impermissible under the statute and implementing regulation, it is also impermissible in the more limited context of the QTL regulation. Consequently, we also decline to approve the "95% test" you suggest whereby insured institutions would be able to count the entire investment in a mutual fund where 95% of its assets are qualified housing related investments under 12 C.F.R. § 583(c).

A final issue to address is how to treat mutual fund investments of FSLIC-insured state-chartered institutions which the QTL regulation includes in its scope. These institutions are not subject to the restrictions imposed on mutual fund investments for Federals, and consequently may have broader mutual fund investment powers than federal associations. It is the opinion of this Office that investments by state-chartered institutions would be permissible for QTL purposes provided the following conditions are met. First, the particular mutual fund should meet all requirements of the applicable state law. Second, an institution may count only that portion of the fund's assets devoted to housing related QTL investments as defined and identified in section 583.27(c).

1/ I note that the Office of General Counsel has issued no action letters with respect to investment in mutual funds in certain limited circumstances including, for example, circumstances where a mutual fund engages in hedging activities to an extent greater than is currently permissible for federal associations. This no action approach does not, however, attempt to expand the investment authority of a federal association beyond its statutory limits. Rather, the mutual fund activities that may trigger a no-action response are different in degree, but not in kind, from those permissible for a federal association.

If you have any further questions on this issue please contact an attorney in the Office of General Counsel).

Sincerely,

Jack D. Smith
Deputy General Counsel

Attachment 2

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

Dear

This responds to your letter of October 3, 1988 requesting the Opinion of the Office of General Counsel respecting certain issues involving the application of the penalties for failing the Qualified Thrift Lender Test ("QTL test") recently enacted as part of the Competitive Equality Banking Act of 1987("CEBA"), Pub. L. No. 100-86, 101 Stat. 552, 12 U.S.C. §1730a(o)(West Supp. 1988). Your questions relate to the limitation imposed on advances which an institution is eligible to receive from its Federal Home Loan Bank. 12 U.S.C. §1430(e)(1); 12 C.F.R. §525.1 (1988). First, you inquire at what point a member who fails the QTL test would be required to purchase additional capital stock: (1) immediately upon failing the QTL test in order to achieve the proper ratio of capital stock to total advances, or (2) prior to receiving any new advance. Second, you inquire whether the advances penalty would be applied to new advances, all advances or only post-CEBA advances.

As explained in more detail below, it is the opinion of this Office that the advances penalty applies only to "post-QTL failure" advances. Further, the affected institution is not required to purchase additional capital stock immediately upon failing the QTL test but, at the time it applies for new advances, it must purchase stock according to the reduced availability formula (as modified) set forth in your October 3 letter.

The limitation imposed on advances is one of two penalties CEBA imposes on institutions failing the QTL test.[1] This limitation as set forth in CEBA and restated in the implementing regulation provides that an FHLBank member that is not a QTL may not receive advances in excess of the amount determined by

1. The other penalty is a restriction on permissible activities of savings and loan holding companies. See 53 Fed. Reg. 312, 319(1988).

multiplying (1) the total amount of advances it would be eligible to receive without reference to the QTL test, by (2) the member's ATIP. 12 U.S.C. §1430(e)(1); 12 C.F.R. §525.1 (1988).

The key to understanding the operation of the advances penalty is discerning the Congressional intent of the penalty and what constitutes failing the QTL test. As evidenced by the excerpt from the Joint Explanatory Statement of the Conference Committee, the purpose of the Test is prospective in nature:

> This provision is intended to apply only prospectively. It does not affect advances or other extensions of credit made, or to be made, pursuant to binding agreements which were entered into by the Federal Home Loan Banks prior to the enactment of this section.

H.R. Conf. Rep. No. 100-261, 100th Cong., 1st Sess. 141 (1987). Without more, however, this leads only to the conclusion that the penalty does not affect advances outstanding on the date CEBA was enacted ("pre-CEBA advances"). A booklet developed by the Office of Regulatory Affairs, CEBA Guide - Questions and Answers ("CEBA Guide") provides further elucidation in its answer to a question whether an institution failing the QTL test would be required to pay down any existing advances:

> The penalty for failing the QTL test is intended to be prospective only. Therefore, while future advances would be limited according to the formula set forth in §525.1, advances outstanding at the time the institution fails the test would not be affected.

CEBA Guide, No. 148 at 68 (1988)(emphasis added). This makes clear that the limitation on advances is intended to apply only to advances subsequent to a failure of the QTL test.[2]

This interpretation makes sense in light of the statutory definition of a failure of the QTL test. It frames the Qualified Thrift Lender Test as follows:

> Any insured institution shall have the status of a qualified thrift lender if--the qualified thrift

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2. The CEBA Guide addresses a related question of interest in the application of the advances penalty. It states that §525.1 does not limit the ATIP to the time a thrift loses QTL status. Rather, the advances limitation may change on a quarterly basis as a thrift's ATIP changes. CEBA Guide, No. 152 at 70 (1988).

> investments of such insured institution equal or exceed 60 percent of the total tangible assets of such institution; and the qualified thrift investments of such insured institution continue to equal or exceed 60 percent of the total tangible assets of such institution on an average basis in 3 out of every 4 quarters and 2 out of every 3 years.

CEBA, tit. I, sec. 104(c)(1), §408(o)(1)(A)-(B), 12 U.S.C. §1730a(o)(1)(A)-(B)(West Supp. 1988). This excerpt sets forth a formula couched in terms of a measuring cycle, i.e., three out of every four quarters in two out of every three years. Under these terms, then, an institution does not fail the QTL test until it goes through one complete measuring cycle.

The regulation promulgated under this section restates the statutory test while further clarifying how to measure the precise moment an institution fails the test:

> An institution shall lose its QTL status at the close of the quarter during which the institution has failed to maintain its actual thrift investment percentage at or above 60 percent, which failure makes it mathematically impossible for the institution to meet the 60 percent actual thrift investment percentage [ATIP] during three out of every four calendar quarters for each of two out of every three calendar years on a continuous basis.

12 C.F.R. §583.27(a)(2)(1988). This leaves little doubt that failing the QTL test is failure based on one complete measuring cycle. Hence, an institution does not fail the test simply because it fails a quarter here or there within a measuring cycle. This in turn requires the conclusion that an institution's advances are not limited just because it happens to fail a particular quarter. See 53 Fed. Reg. 312, 317 (1988). The penalty is applied only at the point it is clear that the institution has failed based on the statutorily mandated measuring cycle. According to the regulation, this occurs at the close of the quarter where it becomes evident that it will be mathematically impossible for the institution to pass the test based on the stated measuring cycle.

It is clear, then, that the penalties for failing the QTL test are prospective in nature and apply only after an institution has failed the test. It is also clear, based on a reading of the relevant statutory provision and its implementing regulation, that QTL failure occurs only at the conclusion of the appropriate measuring cycle. In specific response to your questions, this means the penalty applies only to post- QTL failure advances, not to advances outstanding at the time of failure, nor to the broader category of all post-CEBA advances.

It follows that there would be no need to purchase additional stock immediately upon failing the QTL test because this would have the effect of penalizing advances outstanding at the time of failure which, as discussed above, is not the intent of the test. Rather, as suggested in your letter, the member institution would be required to purchase additional Federal Home Loan Bank capital stock at the time it requests any new advances.

A final issue to resolve is how to apply the formula suggested in your letter for taking account of an institution's reduced eligibility for FHLBank advances following a QTL failure. Your suggested formula is as follows:

1. (principal amount of advances made after CEBA),
   multiplied by

2. (the FHLBank's normal percentage capital stock requirement(5%)),
   multiplied by

3. (one/the member's ATIP)

equals =

The Member's Capital Stock Requirement for Advances Made After CEBA

You applied this formula to the following example: a member with $10 million in advances outstanding ($5 million of which was received after the passage of CEBA) requests an additional $2 million in advances after losing QTL status with a 50% ATIP. The result was as follows:

$7 million ($2M request plus $5M post-CEBA)	X	5%	X	1/50%	=	$700,000 (new stock purchase required)

You explain that, because the member already would have purchased $250,000 in capital stock for the $5 million post-CEBA advances, it would only be required to purchase $450,000 of stock to receive the new $2 million advance.

To properly reflect the interpretation set forth in this letter, some modification of the formula is necessary. First, the advances amount to which the penalty is applied is not all outstanding advances since CEBA (in your example, No. 1 above-$7 million) but rather the amount of the new request submitted after a QTL failure (in your example $2 million). As properly revised (revisions shown in bold, underlined type) the formula would be as follows:

1. (principal amount of advances **requested after failure of QTL test**),

multiplied by

2. (the FHLBank's normal percentage capital stock requirement(5%)),

multiplied by

3. (one/the member's ATIP)

equals =

The Member's Capital Stock Requirement for Advances Made After QTL Failure

Applying the formula to your example but substituting $2 million for $7 million would give the following result:

$2,000,000 x 5% x 1/50% = $200,000

Using the revised figures, in order to obtain the new advance of $2 million, a member with an ATIP of 50% would have to purchase $200,000 worth of new capital stock, or twice the amount it otherwise would have had to purchase had it not lost QTL status.

If you have any questions on this matter, please contact an attorney in this Office, at

Sincerely,

Jack D. Smith
Deputy General Counsel