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Bank Investments in Collateralized Mortgage Obligations (CMOs)

TO: STATE CHARTERED BANKS

Iowa Code Section 524.901 governs state bank investments. Generally, unless the investment is subject to one of the exceptions outlined in section 524.901, a state bank may not invest more than 15% of its aggregate capital in investment securities of any one obligor. But, CMOs present a special case because federal law preempts the state's investment limits for some (but not all) CMOs. *See* the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA), Public Law 98-440, Section 106, Codified as 15 U.S.C. § 77r-1.

This Superintendent Guidance interprets the application of investment limits outlined in Iowa Code § 524.901 to CMOs in light of 15 U.S.C. §§ 77r-1 and 78c(a)(41) (relevant provisions of SMMEA). *See* Iowa Code § 524.213.

Please note the changes the Dodd-Frank Act made to recognition of Nationally Recognized Statistical Rating Organizations (NRSRO) will impact application of the law to bank investment in private label CMOs. These changes will not take effect until July 21, 2012. *See* below for further discussion of the impact of these changes.

Current Application of Investment Limits to CMOs

Banks may hold, in an unlimited amount, any government guaranteed CMO (including CMOs issued or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae). *See* 15 U.S.C. § 77r-1(1)(D) and Iowa Code § 524.901(3)(a).

Banks may hold, in an unlimited amount, any private label CMO rated in the top two rating categories (AAA or AA) by at least one NRSRO. This is the result of SMMEA, that preempts application of state's investment limit law applicable to "mortgage related securities" as that term is defined in 12 U.S.C. 78c(a)(41). *See* 15 U.S.C. § 77r-1(1)(B).

Private label CMOs that are not rated AAA or AA by a NRSRO are subject to the limitations in Iowa Code § 524.901.

Currently, the SEC determines whether an entity is a NRSRO. [See 15 U.S.C. § 78c(62).] The following SEC website (<http://www.sec.gov/divisions/marketreg/ratingagency.htm#cguides>) contains links to SEC orders granting NRSRO status. As of January 2012, the following organizations have been approved by the SEC as NRSROs:

A.M. Best Company, Inc.
DBRS Ltd.
Egan-Jones Rating Company
Fitch, Inc.
Japan Credit Rating Agency, Ltd.
LACE Financial Corp.
Moody's Investors Service, Inc.
Rating and Investment Information, Inc.
Realpoint LLC
Standard & Poor's Ratings Services

If another company that is not a NRSRO produces a rating using a model acquired from a NRSRO, that rating would not qualify as an investment rating in the top two categories by at least one NRSRO.

In the current economic environment, many NRSROs are revisiting the ratings given to CMOs. In some cases this has resulted in a NRSRO downgrading an outdated rating. Occasionally, a CMO issue that was originally rated by more than one NRSRO has not been revisited by all NRSROs that originally rated the issue. In these cases, the Superintendent believes safety and soundness considerations dictate that banks should rely on current ratings to determine whether an investment is appropriate for a state bank or whether it is subject to the 15% investment limit established in Iowa Code § 524.901. As a result, state banks purchasing CMOs should check at least two ratings agencies at the time it purchases the CMO. The bank shall use the most current rating at the time of purchase to determine whether the CMO is appropriate for the bank or is subject to the 15% investment limit established in Iowa Code § 524.901. The bank should retain documentation of the ratings it reviewed at the time of its purchase with its investment file.

If a private label CMO was rated by a NRSRO as AAA or AA when the bank purchased it, but falls below the top two investment ratings while the bank is holding it, it will not be cited as a violation of 524.901 and the bank will not be required to dispose of the CMO. But, the examiner may still assess the quality of the investment and may adversely classify it.

Private label CMOs that are not rated in the two highest grades by a NRSRO at the time of purchase are subject to the 15% limitation in 524.901, provided they are within the four highest grades per a NRSRO or represent unrated securities of equivalent quality. *See* 524.901(1)(a)(defining “investment securities” to include “unrated issues of equivalent value” to securities within the four highest grades).

Important: Future Changes to CMO Investment Limits

The Dodd-Frank Act made significant changes to the recognition of NRSROs in federal law and regulations. These changes include a change to the definition of “mortgage related security” that will be effective July 21, 2012. Currently, 15 U.S.C. 78c(a)(41) defines “mortgage related security” to mean “a security that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization, and [meets some additional standards].” As of July 21, 2012, the definition will be changed to mean “a security that meets standards of credit-worthiness as established by the [Securities and Exchange] Commission.” Dodd-Frank Act, § 939(e). The SEC has not yet promulgated regulations regarding standards of credit-worthiness.

After July 21, 2012, a state bank’s investment in private label CMOs will be limited by the provisions of Iowa Code § 524.901, unless the CMO meets the standards of credit-worthiness established by the SEC. CMOs meeting the SEC’s standards of credit-worthiness will not be subject to an investment limit.

If a state bank purchases a private label CMO rated by a NRSRO as AAA or AA at the time of purchase before July 21, 2012, it will not be cited as a violation of 524.901 and the bank will not be required to dispose of the CMO. Because asset quality presents a separate issue from investment limits, the examiners may still assess the quality of the investment and may adversely classify it.

Additional Considerations

This Superintendent Guidance has addressed the authorization for state banks to invest in CMOs and applicable investment limits. Banks considering investing in CMOs (both government guaranteed and private label) and holding such investments should conduct an independent assessment of the risks associated with the investment. Banks should not rely on the analysis of a third party that is selling the CMO to the bank.

Sincerely,



James M. Schipper
Superintendent of Banking

Please note: This Iowa Division of Banking Superintendent Guidance #2012-01 replaces the Interpretive Bulletin dated August 19, 1987, relating to bank investments in Collateralized Mortgage Obligations (CMOs).