AMENDMENTS TO INVESTMENT SECURITIES REGULATION

Attention: Chief Executive Officer of Each Tenth District State Member Bank


Highlights: The Federal Reserve issued SR letter 12-15 on November 15, 2012 to advise state member banks that, effective January 1, 2013, they may no longer rely solely on credit ratings issued by nationally recognized statistical rating organizations (external credit ratings) to determine whether a particular security is "investment grade."

The supervisory letter highlights that state member banks are subject to the Office of the Comptroller of the Currency (OCC) regulation, 12 C.F.R. part 1, and recent revisions to the regulation removing references to credit ratings. Banks subject to the rule will be required to make assessments of a security's creditworthiness to determine if it is investment grade.

A state member bank may continue to take into account external credit ratings and assessments as valuable sources of information. Banks will need to supplement ratings information with due diligence processes appropriate for the bank’s risk profile and for the size and complexity of the instrument. Third-party analytics may be part of this analysis, although bank management remains responsible for the investment decision and should ensure that prospective third parties are independent, reliable, and qualified. Additional detail is included in SR letter 12-15 and the related OCC guidance.

Attachment: A copy of SR letter 12-15 and the OCC Guidance on Due Diligence Requirements in Determining Whether Securities are Eligible for Investment.

Internet Link: A copy of SR letter 12-15 and the related OCC guidance are available on the Federal Reserve Board’s web site at:
http://www.federalreserve.gov/bankinforeg/srletters/sr1215.htm

Contact: Questions regarding this letter may be directed to:
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TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK

SUBJECT: Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings

Applicability to Community Banking Organizations: This guidance applies to all state member banks, including those with $10 billion or less in consolidated assets.

The Federal Reserve is issuing this letter to advise state member banks that effective January 1, 2013, they may no longer rely solely on credit ratings issued by nationally recognized statistical rating organizations (external credit ratings) to determine whether a particular security is an "investment security" that is permissible for investment by a state member bank. Under regulations of the Office of the Comptroller of the Currency (OCC), securities qualify for investment by national banks only if they are determined by the bank to be "investment grade" and not predominantly speculative in nature. This letter provides background on recent statutory changes and actions of the OCC to amend its regulation on investment securities, which also applies to state member banks.

Under the Federal Reserve Act (12 USC 335) and the Federal Reserve’s Regulation H (12 CFR 208.21), state member banks are subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as national banks under the National Banking Act (12 USC 24 (Seventh)). Therefore, when investing in securities, state member banks must comply with the provisions of the National Banking Act and the OCC regulations in 12 CFR part 1. In addition to this federal requirement, a state member bank may purchase, sell, underwrite, or hold securities and stock only to the extent permitted under applicable state law.

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires each federal agency to remove references to, and requirements of reliance on, external credit ratings in any regulation issued by the agency that requires the assessment of the creditworthiness of a security or money market instrument. The agencies also are required to
substitute an alternative standard of creditworthiness. Pursuant to this requirement, the OCC published a final rule and guidance on June 13, 2012, that revises 12 CFR part 1 by removing references to external credit ratings and generally requiring national banks to make assessments of a security’s creditworthiness to determine if it is “investment grade.” This requirement is similar to existing OCC standards for the purchase of unrated securities by national banks. The final rule is effective January 1, 2013 for existing and future national bank holdings of investment securities.

Under the revised rule, a security meets the “investment grade” test only if the issuer has an adequate capacity to meet its financial commitments under the security for the projected life of the asset or exposure. Under this definition, the issuer has an adequate capacity to meet financial commitments if (1) the risk of default by the obligor is low and (2) the full and timely repayment of principal and interest is expected. As explained in the Federal Register publication of the final rule, the OCC expects national banks to consider a number of factors, to the extent appropriate in making this determination. While a national bank may continue to take into account external credit ratings and assessments as a valuable source of information, the bank is expected to supplement these ratings with a degree of due diligence processes and additional analyses appropriate for the bank’s risk profile and for the size and complexity of the instrument.

Concurrent with the final rule, the OCC published final guidance, also effective January 1, 2013 (OCC investment guidance), to clarify regulatory expectations with respect to investment purchase decisions and ongoing portfolio due diligence processes. The guidance, which is attached, clarifies that generally, investment securities are expected to have good to very strong credit quality. In the case of structured securities, this determination may be influenced more by the quality of the underlying collateral, the cash flow rules, and the structure of the security itself than by the condition of the issuer.

The OCC also expects national banks to conduct an appropriate level of due diligence to understand the inherent risks of a security and determine that it is a permissible investment. The extent of the due diligence should be sufficient to support the institution’s conclusion that a security meets the “investment-grade” standards. The depth of the due diligence should be a function of the security’s credit quality, the complexity of the structure, and the size of the investment. Third-party analytics may be part of this analysis, although the national bank’s management remains responsible for the investment decision and should ensure that prospective third parties are independent, reliable, and qualified. The guidance also sets forth an expectation that the board of directors should oversee management to make sure appropriate decision-making processes are in place.

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1 See 15 USC 78o-7, note.
2 For the OCC’s final rules, see 77 FR 35253 (June 13, 2012). For the OCC’s guidance, see 77 FR 35259 (June 13, 2012) and OCC Bulletin 2012-18 (June 26, 2012).
3 See 77 FR 35257 (June 13, 2012).
4 See 77 FR 35254 (June 13, 2012).
5 See 77 FR 35259 (June 13, 2012).
Investment in securities and stock by state member banks are required under the Federal Reserve Act and Regulation H to comply with the revised 12 CFR part 1 and should also meet the supervisory expectations set forth in the OCC investment guidance and this guidance. In addition, state member banks are expected to continue to meet long-established supervisory expectations for risk-management processes to ensure that the credit risk of the bank, including the credit risk of the investment portfolio, is effectively identified, measured, monitored, and controlled. As noted above, investments by state member banks must also comply with applicable state law.

Many of these expectations are set forth in the 1998 interagency Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (SR letter 98-12, “FFIEC Policy Statement on Investment Securities and End-User Derivatives Activities”), which provides risk-management standards for the securities investment activities of banks and savings associations. SR 98-12 emphasizes the importance of an institution conducting a thorough credit-risk analysis before and periodically after the acquisition of a security. Such analysis would allow an institution to understand and effectively manage the risks within its investment portfolio, including credit risk, and is an essential element of a sound investment portfolio risk-management framework. The supervisory expectations set forth in SR 98-12 provide criteria that institutions can use in meeting the requirements of 12 CFR part 1, and state member banks should use the expectations set forth in that guidance with respect to investing in nonrated securities when determining to invest in any security.

Reserve Banks are asked to distribute this letter to state member banks supervised by the Federal Reserve in their districts, as well as to their own application, supervisory, and examination staff. Questions regarding the attached guidance should be addressed to the following staff in the Credit, Market & Liquidity Risk Policy section: Christopher McBride, Senior Supervisory Financial Analyst, at (202) 452-3814; or Mary Aiken, Manager, at (202) 721-4534. In addition, questions may be sent via the Board’s public website.6

Michael S. Gibson
Director

Cross-reference:

Attachment:
- OCC Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment

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Attachment

OCC Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment

The guidance below was issued by the Office of the Comptroller of the Currency (OCC) on June 13, 2012, and is being replicated as an attachment to this letter for ease of reference for state member banks and Federal Reserve supervisory staff. The official guidance was published in the Federal Register (77 FR 35259), and is available as an attachment to OCC Bulletin 2012-18. As discussed in this SR letter, the Federal Reserve also expects that state member banks will meet the supervisory expectations set forth in the OCC guidance as this guidance provides further clarification to the OCC rule with which state member banks must comply. (See 12 CFR Part 1, and 77 FR 35253, June 13, 2012.)

Purpose

The OCC has issued final rules to revise the definition of “investment grade,” as that term is used in 12 CFR parts 1 and 160 in order to comply with section 939A of the Dodd-Frank Act. Institutions have until January 1, 2013, to ensure that existing investments comply with the revised “investment grade” standard, as applicable based on investment type, and safety and soundness practices described in 12 CFR 1.5 and this guidance. This implementation period also will provide management with time to evaluate and amend existing policies and practices to ensure new purchases comply with the final rules and guidance. National banks and Federal savings associations that have established due diligence review processes as described in previous guidance, and that have not relied exclusively on external credit ratings, should not have difficulty establishing compliance with the new standard.

The OCC is issuing this guidance (“Guidance”) to clarify steps national banks ordinarily are expected to take to demonstrate they have properly verified their investments meet the newly established credit quality standards under 12 CFR Part 1 and steps national banks and Federal savings associations are expected to take to demonstrate they are in compliance with due diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios. Federal savings associations will need to follow FDIC requirements when that agency promulgates credit quality standards under 12 U.S.C. 1831e. The standards below describe how national banks may purchase, sell, deal in, underwrite, and hold securities consistent with the authority contained in 12 U.S.C. 24 (Seventh), and how Federal saving associations may invest in, sell, or otherwise deal in securities consistent with the authority contained in 12 U.S.C. 1464(c). The activities of national banks and Federal savings associations also must be consistent with safe and sound banking practices, and this Guidance reminds national banks and Federal savings associations of the supervisory risk management expectations associated with permissible investment portfolio holdings under Part 1 and Part 160.

Background

Parts 1 and 160 provide standards for determining whether securities have appropriate credit quality and marketability characteristics to be purchased and held by national banks or
Federal savings associations. These requirements also establish limits on the amount of investment securities an institution may hold for its own account. As defined in 12 CFR Part 1, an “investment security” must be “investment grade.” For the purpose of Part 1, “investment grade” securities are those where the issuer has an adequate capacity to meet the financial commitments under the security for the projected life of the investment. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected. Generally, securities with good to very strong credit quality will meet this standard. In the case of a structured security (that is, a security that relies primarily on the cash flows and performance of underlying collateral for repayment, rather than the credit of the entity that is the issuer), the determination that full and timely repayment of principal and interest is expected may be influenced more by the quality of the underlying collateral, the cash flow rules, and the structure of the security itself than by the condition of the issuer.

National banks and Federal savings associations must be able to demonstrate that their investment securities meet applicable credit quality standards. This Guidance provides criteria that national banks can use in meeting Part 1 credit quality standards and that national banks and Federal savings associations can use in meeting due diligence requirements.

Determining Whether Securities Are Permissible Prior to Purchase

The OCC’s elimination of references to credit ratings in its regulations, in accordance with the Dodd-Frank Act, does not substantively change the standards institutions should use when deciding whether securities are eligible for purchase under Part 1. The OCC’s investment securities regulations generally require a national bank or Federal savings association to determine whether or not a security is “investment grade” in order to determine whether purchasing the security is permissible. Investments are considered “investment grade” if they meet the regulatory standard for credit quality. To meet this standard, a national bank must be able to determine that the security has (1) low risk of default by the obligor, and (2) the full and timely repayment of principal and interest is expected over the expected life of the investment.¹ A Federal savings association must meet the same standard when purchasing certain municipal revenue bonds pursuant to 12 CFR 160.24 and must meet the standards in 12 U.S.C. 1831e when purchasing corporate debt securities.

For national banks, Type I securities, as defined in Part 1, generally are government obligations and are not subject to investment grade criteria for determining eligibility to purchase. Typical Type I obligations include U.S. Treasuries, agencies, municipal government general obligations, and for well-capitalized institutions, municipal revenue bonds. While Type I obligations do not have to meet the investment grade criteria to be eligible for purchase, all investment activities should comply with safe and sound banking practices as stated in 12 CFR

¹ Federal savings associations may invest in and hold investment securities under section 5(c) of the Home Owners’ Loan Act (HOLA), to the extent specified in regulations of the OCC. While OCC regulations imposing investment limitations generally apply to Federal savings associations, the Federal Deposit Insurance Act (FDIA), 12 U.S.C. 1831e(d)(1) also applies. Under this provision, savings associations currently are prohibited from investing in corporate debt securities unless they are rated “investment grade.” However, the Dodd-Frank Act provides that on July 21, 2012, this statutory requirement will be replaced by standards of creditworthiness established by the FDIC. Pub. L. 111–203, Section 939(a)(2) (July 21, 2010).
1.5 and in previous regulatory guidance. Under OCC rules, Treasury and agency obligations do not require individual credit analysis, but bank management should consider how those securities fit into the overall purpose, plans, and risk and concentration limitations of the investment policies established by the board of directors. Municipal bonds should be subject to an initial credit assessment and then ongoing review consistent with the risk characteristics of the bonds and the overall risk of the portfolio.

Financial institutions should be well acquainted with fundamental credit analysis as this is central to a well-managed loan portfolio. The foundation of a fundamental credit analysis—character, capacity, collateral, and covenants—applies to investment securities just as it does to the loan portfolio. Accordingly, the OCC expects national banks and Federal savings associations to conduct an appropriate level of due diligence to understand the inherent risks and determine that a security is a permissible investment. The extent of the due diligence should be sufficient to support the institution’s conclusion that a security meets the investment grade standards. This may include consideration of internal analyses, third party research and analytics including external credit ratings, internal risk ratings, default statistics, and other sources of information as appropriate for the particular security. Some institutions may have the resources to do most or all of the analytical work internally. Some, however, may choose to rely on third parties for much of the analytical work. While analytical support may be delegated to third parties, management may not delegate its responsibility for decision-making and should ensure that prospective third parties are independent, reliable, and qualified. The board of directors should oversee management to assure that an appropriate decision-making process is in place.

The depth of the due diligence should be a function of the security’s credit quality, the complexity of the structure, and the size of the investment. The more complex a security’s structure, the more credit-related due diligence an institution should perform, even when the credit quality is perceived to be very high. Management should ensure it understands the security’s structure and how the security may perform in different default environments, and should be particularly diligent when purchasing structured securities. The OCC expects national banks and Federal savings associations to consider a variety of factors relevant to the particular security when determining whether a security is a permissible and sound investment. The range and type of specific factors an institution should consider will vary depending on the particular type and nature of the securities. As a general matter, a national bank or Federal savings association will have a greater burden to support its determination if one factor is contradicted by a finding under another factor.

The following matrix provides examples of factors for national banks and Federal savings associations to consider as part of a robust credit risk assessment framework for designated types of instruments. The types of securities included in the matrix require a credit-focused pre-purchase analysis to meet the investment grade standard or safety and soundness standards. Again, the matrix is provided as a guide to better inform the credit risk assessment process. Individual purchases may require more or less analysis dependent on the security’s risk characteristics, as previously described.

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2 For example, a national bank or Federal savings association should be able to demonstrate an understanding of the effects on cash flows of a structured security assuming varying default levels in the underlying assets.
<table>
<thead>
<tr>
<th>Key factors</th>
<th>Corporate bonds</th>
<th>Municipal government general obligations</th>
<th>Revenue bonds</th>
<th>Structured securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Confirm risk of default is low and consistent with bonds of similar credit quality</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Confirm capacity to pay and assess operating and financial performance levels and trends through internal credit analysis and/or other third party analytics, as appropriate for the particular security</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Evaluate the soundness of a municipal’s budgetary position and stability of its tax revenues. Consider debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority, and management experience</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Understand local demographics/economics. Consider unemployment data, local employers, income indices, and home values</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assess the source and strength of revenue structure for municipal authorities. Consider obligor’s financial condition and reserve levels, annual debt service and debt coverage ratio, credit enhancement, legal covenants, and nature of project</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Understand the class or tranche and its relative position in the securitization structure</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assess the position in the cash flow waterfall</td>
<td>X</td>
<td></td>
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<tr>
<td>Understand loss allocation rules, specific definition of default, the potential impact of performance and market value triggers, and support provided by credit and/or liquidity enhancements</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Evaluate and understand the quality of the underwriting of the underlying collateral as well as any risk concentrations</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Determine whether current underwriting is consistent with the original underwriting underlying the historical performance of the collateral and consider the affect of any changes</td>
<td>X</td>
<td></td>
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</tr>
<tr>
<td>Assess the structural subordination and determine if adequate given current underwriting standards</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Analyze and understand the impact of collateral deterioration on tranche performance and potential credit losses under adverse economic conditions</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Additional Guidance on Structured Securities Analysis

The creditworthiness assessment for an investment security that relies on the cash flows and collateral of the underlying assets for repayment (i.e., a structured security) is inherently different from a security that relies on the financial capacity of the issuer for repayment. Therefore, a financial institution should demonstrate an understanding of the features of a structured security that would materially affect its performance and that its risk of loss is low even under adverse economic conditions. Management’s assessment of key factors, such as those provided in this guidance, will be considered a critical component of any structured security evaluation. Existing OCC guidance, including OCC Bulletin 2002-19, “Supplemental Guidance, Unsafe and Unsound Investment Portfolio Practices,” states that it is unsafe and unsound to purchase a complex high-yield security without an understanding of the security’s structure and performing a scenario analysis that evaluates how the security will perform in different default environments. Policies that specifically permit this type of investment should establish appropriate limits, and pre-purchase due diligence processes should consider the impact of such purchases on capital and earnings under a variety of possible scenarios. The OCC expects institutions to understand the effect economic stresses may have on an investment’s cash flows. Various factors can be used to define the stress scenarios. For example, an institution could evaluate the potential impact of changes in economic growth, stock market movements, unemployment, and home values on default and recovery rates. Some institutions have the resources to perform this type of analytical work internally. Generally, analyses of the application of various stress scenarios to a structured security's cash flow are widely available from third parties. Many of these analyses evaluate the performance of the security in a base case and a moderate and severe stress case environment. Even under severe stress conditions, the stress scenario analysis should determine that the risk of loss is low and full and timely repayment of principal and interest is expected.

Maintaining an Appropriate and Effective Portfolio Risk Management Framework

The OCC has had a long-standing expectation that national banks implement a risk management process to ensure credit risk, including credit risk in the investment portfolio, is effectively identified, measured, monitored, and controlled. The 1998 Interagency Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (Policy Statement) contains risk management standards for the investment activities of banks and savings associations. The Policy Statement emphasizes the importance of establishing and maintaining risk processes to manage the market, credit, liquidity, legal, operational, and other risks of investment securities. Other previously issued guidance that supplements OCC investment standards are OCC 2009-15, “Risk Management and Lessons Learned” (which highlights lessons learned during the market disruption and re-emphasizes the key principles discussed in previously issued OCC guidance on portfolio risk management); OCC 2004–25, “Uniform Agreement on the Classification of Securities” (which describes the importance of management’s credit risk analysis and its use in examiner decisions concerning investment security risk ratings and classifications); and OCC 2002-19, “Supplemental Guidance, Unsafe
and Unsound Investment Portfolio Practices” (which alerts banks to the potential risk to future earnings and capital from poor investment decisions made during periods of low levels of interest rates and emphasizes the importance of maintaining prudent credit, interest rate, and liquidity risk management practices to control risk in the investment portfolio). 4

National banks and Federal savings associations must have in place an appropriate risk management framework for the level of risk in their investment portfolios. Failure to maintain an adequate investment portfolio risk management process, which includes understanding key portfolio risks, is considered an unsafe and unsound practice.

Having a strong and robust risk management framework appropriate for the level of risk in an institution’s investment portfolio is particularly critical for managing portfolio credit risk. A key role for management in the oversight process is to translate the board of directors’ tolerance for risk into a set of internal operating policies and procedures that govern the institution’s investment activities. Policies should be consistent with the organization’s broader business strategies, capital adequacy, technical expertise, and risk tolerance. Institutions should ensure that they identify and measure the risks associated with individual transactions prior to acquisition and periodically after purchase. This can be done at the institutional, portfolio, or individual instrument level. Investment policies also should provide credit risk concentration limits. Such limits may apply to concentrations relating to a single or related issuer, a geographical area, and obligations with similar characteristics. Safety and soundness principles warrant effective concentration risk management programs to ensure that credit exposures do not reach an excessive level.

The aforementioned risk management policies, principles, and due diligence processes should be commensurate with the complexity of the investment portfolio and the materiality of the portfolio to the financial performance and capital position of the institution. Investment review processes, following the pre-purchase analysis, may vary from institution to institution based on the individual characteristics of the portfolio, the nature and level of risk involved, and how that risk fits into the overall risk profile and operation of the institution. Investment portfolio reviews may be risk-based and focus on material positions or specific groups of investments or stratifications to enable analysis and review of similar risk positions.

As with pre-purchase analytics, some institutions may have the resources necessary to do most or all of their portfolio reviews internally. However, some may choose to rely on third parties for much of the analytical work. Third party vendors offer risk analysis and data benchmarks that could be periodically reviewed against existing portfolio holdings to assess credit quality changes over time. Holdings where current financial information or other key analytical data is unavailable should warrant more frequent analysis. High quality investments generally will not require the same level of review as investments further down the credit quality spectrum. However, any material positions or concentrations should be identified and assessed in more depth and more frequently, and any system should ensure an accurate and timely risk assessment and reporting process that informs the board of material changes to the risk profile and prompts action when needed. National banks and Federal savings associations should have

4 Similar requirements also apply to Federal savings associations as set forth in OTS Examination Handbook Section 540, Investment Securities (January 2010).
investment portfolio review processes that effectively assess and manage the risks in the portfolio and ensure compliance with policies and risk limits. Institutions should reference existing regulatory guidance for additional supervisory expectations for investment portfolio risk management practices.