

June 28, 2012

**MEMORANDUM TO:** Board of Directors

**FROM:** Sandra L. Thompson, Director  
Division of Risk Management Supervision

**SUBJECT:** *Final Rule Regarding Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities; Final Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security is Eligible for Investment Under Part 362*

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**Proposal:** That the Board of Directors (“Board”) of the Federal Deposit Insurance Corporation (“FDIC”) approve the attached final rule titled, *Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities* and the final guidance document titled, *Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security is Eligible for Investment Under Part 362*.

The final rule, if approved, would clarify the proposed creditworthiness standard as described below. In the final rule, the phrase “projected life of the investment” has been revised to “projected life of the security” to more closely track the language in the Office of the Comptroller of the Currency’s (“OCC”) final rule. The clarifying revision addresses ambiguities in the proposed rule and harmonizes the final rule with the final rule adopted by the OCC regarding permissible investments for national banks.

Additionally, after considering the comments received on the notice of proposed rulemaking (“NPR” or “proposed rule”) published December 15, 2011 in the *Federal Register*, the proposed rule is being finalized without changing the level of due diligence required by savings associations. While commenters were concerned about the amount of due diligence that the FDIC would require a savings association to conduct, the FDIC staff believes that the proposed standard of creditworthiness and the due diligence required to meet it are consistent with those under prior ratings-based standards and existing due diligence requirements and guidance. Even under the ratings-based standard set forth in part 362, savings associations are expected to avoid sole reliance on a credit rating to evaluate the credit risk of a security, and consistently have been advised through guidance and other supervisory materials to supplement any use of credit ratings

Concur:

Richard J. Osterman Jr.  
Acting General Counsel

with additional research on the credit risk of a particular security. Accordingly, the FDIC staff does not expect the final rule to materially change the investment risk-management practices of most savings associations or the scope of permissible corporate debt securities investments under part 362.

The final rule is effective July 21, 2012. However, due to industry concerns about saving associations having insufficient time to develop processes for making creditworthiness determinations, the final rule provides for a transition period until January 1, 2013. The FDIC will not require compliance with the rule until the end of the transition period, January 1, 2013.

Together with the proposed rule, the FDIC also issued a proposed guidance document on December 15, 2011, in the *Federal Register* to seek public comment. The proposed guidance document assists savings associations in conducting due diligence to determine whether a corporate debt security is eligible for investment under the rule by setting forth the criteria a savings association should expect to consider in making a creditworthiness determination. If approved, the final guidance document would adopt the proposed guidance document with additional clarifying revisions adopted in the final rule, but otherwise, without change.

**Discussion:** Section 28(d) of the Federal Deposit Insurance Act (“section 28(d)”) currently prohibits savings associations from acquiring or retaining a corporate debt security that is not “of investment grade.” Effective July 21, 2012, section 939(a) (“section 939(a)”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) amends section 28(d) to prohibit savings associations from acquiring or retaining a corporate debt security that does not satisfy creditworthiness standards established by the FDIC.

Part 362 of the FDIC’s regulations, 12 C.F.R. Part 362, implements section 28(d) and sets forth the requirements, restrictions, and limitations applicable to the investment activities of insured state savings associations. In accordance with the requirements of section 28(d) as amended by section 939(a), the final rule revises part 362 to prohibit a savings association from acquiring or retaining a corporate debt security unless the savings association, prior to acquiring the security, and periodically thereafter, determines that the issuer of the security has adequate capacity to meet all financial commitments under the security for the projected life of the security. An issuer satisfies this requirement if it presents a low risk of default and is likely to make full and timely repayment of principal and interest. The final rule applies to state and federal savings associations. (Currently the requirements of part 362 regarding permissible corporate debt security investments of a savings association apply only to state savings associations.) The final rule does not revise current supervisory practice with respect to nonconforming corporate debt securities investments. That is, if a security acquired in compliance with the final rule experiences credit impairment or other deterioration following its acquisition, the appropriate federal regulator may require the savings association to take corrective measures on a case-by-case basis.

The final rule is consistent with the standards of creditworthiness adopted or proposed for adoption by other federal agencies in accordance with the requirements of section 939A of the

rule does not revise current supervisory practice with respect to nonconforming corporate debt securities investments. That is, if a security acquired in compliance with the final rule experiences credit impairment or other deterioration following its acquisition, the appropriate federal regulator may require the savings association to take corrective measures on a case-by-case basis.

The final rule is consistent with the standards of creditworthiness adopted or proposed for adoption by other federal agencies in accordance with the requirements of section 939A of the Dodd-Frank Act.<sup>2</sup> For example, the OCC published a final rule on June 13, 2012, which revises its regulations pertaining to investment securities, securities offerings, and foreign bank capital equivalency deposits to replace references to credit ratings with alternative standards of creditworthiness. To meet the new standard, national banks must determine that the issuer of the security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure, similar to the FDIC's final rule.

The FDIC received five comments on the proposed rule and guidance document. While commenters generally support the proposed rule and guidance, commenters expressed concern over the type and depth of analysis required. For instance, one commenter asked for differentiations of due diligence requirements based on the size and scope of the association. The final rule, however, includes the same standard for due diligence as the proposed rule and does not include a threshold based on the size of the institution. The standard for making the creditworthiness determination is consistent with the existing investment risk management practices of savings associations, which currently are expected to maintain a risk management process to ensure that credit risk is effectively identified, measured, monitored, and controlled.<sup>3</sup> Effective risk management requires consideration of and due diligence based on factors other than an external credit assessment. Accordingly, the final rule should not impose a significant burden on federal or state savings associations of any size or affect the scope of securities currently eligible for investment by a savings association under part 362.

The final rule is accompanied by a final guidance document that sets forth the FDIC's expectations for savings associations conducting due diligence to determine whether a corporate debt security is eligible for investment under the final rule. The final guidance describes several factors that savings associations should consider in making this determination. For example, the final guidance recommends considering internal analyses, third-party research and analytics including external credit ratings, internal risk ratings, default statistics, and other sources of information appropriate for the particular security. However, 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.

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<sup>2</sup> 77 Federal Register 25253 (June 13, 2012). The purposes of section 939A of the Dodd-Frank Act are similar to the purpose of section 939(a).

<sup>3</sup> On April 23, 1998, the FDIC, together with the Federal Reserve Board, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision, issued the "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities." As issued by the OTS, the Policy Statement applied to both state and Federal savings associations.

In the NPR, the FDIC proposed an effective date of July 21, 2012, in accordance with Section 939(a). The final rule adopts the effective date as proposed. Industry commenters were concerned that savings associations would have insufficient time to develop processes for making creditworthiness determinations on new securities purchased before the effective date. These commenters suggested that the FDIC adopt a one-year transition period before the FDIC requires compliance with the rule. One commenter also requested an additional year beyond the transition period to allow for review of existing securities held by the institution. Staff recognizes that it may take time for some savings associations to develop the systems and processes necessary to make creditworthiness determinations under the new standard. Therefore, the final rule provides for a transition period until January 1, 2013, to allow institutions to come into compliance with the rule.

The final rule does not grandfather any corporate debt securities acquired before the effective date and, therefore, savings associations are permitted to retain only those securities for which the savings association determines that (as of the effective date and periodically thereafter) the issuer has adequate capacity to satisfy all financial commitments under the security for the projected life of the security. This treatment for previously acquired securities is consistent with the requirements of section 28(d) and the final rule, which prohibit a savings association from acquiring or retaining any corporate debt security that does not satisfy the creditworthiness standard described in the final rule. Savings associations have until January 1, 2013 to evaluate their existing holdings and ensure that they meet the revised standard.

The FDIC currently may require a state savings association to take corrective measures in the event a corporate debt security experiences a downgrade (to non-investment grade status) following acquisition. For example, a savings association may be required to reduce the level of non-investment grade corporate debt security investments as a percentage of tier 1 or total capital, write-down the value of the security to reflect an impairment, or divest the security. The FDIC addresses nonconforming investments on a case-by-case basis through the examination process, and in view of the risk profile of the savings association and size and composition of its investment portfolio.

As stated above, the OCC published in the *Federal Register* on June 13, 2012, a final rule to amend part 1, Investment Securities, in a manner consistent with the requirements of this final rule. The OCC final rule permits a national bank to consider a credit rating as one of several factors in determining whether a security is eligible for investment under part 1 of the OCC's regulations. The effective date for similar OCC revisions is January 1, 2013.

**Recommendation:** That the Board approves publication of this final rule and final guidance in the *Federal Register*.

RMS Contacts: Bobby Bean (ext. 86705)  
Kyle Hadley (ext. 86532)  
Eric Reither (ext. 83707)

Legal Division Contacts: Suzanne Dawley (ext. 86509)  
Rachel Jones (ext. 86858)