Investment Securities - New Rules for Assessing Credit Risk

2014 FDIC Chicago Region Regulatory Conference Call Series

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You can submit questions via the operator or by email during the call at chiconferencecall@FDIC.gov

The opinions expressed here are those of the presenters and do not necessarily reflect the views of the FDIC. Please refer to regulatory guidance for official FDIC views on the topics.

Agenda

Office of the Comptroller of the Currency (OCC) regulatory guidance issued in 2012 removes references to credit ratings in regulations pertaining to investment securities. The Interagency Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions issued in 2013 applies these changes to treatment of securities for examination classification purposes.

- **What to expect during the examination process**
- **How removal of reliance upon agency ratings in bank regulations has changed examiner expectations for bank due diligence on securities**
- **Illustrative examples of the new regulation application**
- **Strategies to manage securities holdings in the context of this new guidance**

Background

- The Dodd Frank Act (Section 939A) requires removal of references to credit ratings in regulations.

- As a result, the OCC adopted a rule removing references to credit agency ratings as a standard for investment grade in OCC regulations governing national banks. A security rated in the top four categories (AAA, AA, A, BBB) by a credit rating service alone would no longer automatically satisfy the revised investment grade standard. The OCC guidance became effective January 1, 2013 (77 Fed. Reg. 35253).

- FDIC-supervised banks generally are prohibited via FDIC Rules and Regulations, Part 362, from engaging in investment activities that are impermissible for a national bank, as determined by OCC guidance.

- Accordingly, the FDIC adopted the OCC guidance through release of FDIC FIL-48-2012.

- The Interagency Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions, issued in 2013 as FIL-51-2013, applies these changes to examiner classifications of securities.

For investments, two main impacts:

1. Permissibility is redefined.
2. Banks need to perform due diligence relative to the new permissibility benchmark (risk assessment and classification).

Permissibility still hinges on the definition of “investment grade”.

Previously -

- **Banks relied upon an investment grade that was defined as securities having a credit rating of BBB- or above.**

Now -

- **Banks need to show that an issuer has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure.**
- **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.**

Due Diligence

- **Bank management needs to ensure that it understands a security's structure and how the security may perform under adverse economic conditions.**

- **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.**

What can bankers expect during the examination process?

- Likely biggest impact for banks will be on municipal bond investments (due to typically limited corporate debt holdings at most community banks).
- Future supervisory reviews will likely include more focus on credit risk management practices.
- Bank policies and procedures may need to be altered.
- Credit agency ratings can be used, but other factors must also be considered and documented.
- Credit risk management should be commensurate with the level of risk, though even small exposures require some minimum level of monitoring and due diligence.
- Data and analysis can be outsourced, but the final purchase decision still remains with the bank.

How has removal of reliance upon ratings changed examiner expectations for due diligence on securities?

Bank examiners will expect:

- **More detailed reviews of investment credit risk management, particularly at banks with material credit risk exposure**
- **Evaluation of whether sufficient support exists for permissibility and investment grade quality**
- **Ensuring credit risk management practices are compliant with OCC guidance**

How has removal of reliance upon ratings changed examiner expectations for due diligence on securities? (continued)

Bank examiners will expect:

- **Credit reviews should be performed both pre- and post-purchase**

- **Credit analysis and conclusions should be documented**

- **Investment policies should specify additional constraints beyond just credit agency ratings, such as:**
  - **Concentration limits on issuer or sector,**
  - **Minimum credit criteria or thresholds for credit metrics used, and**
  - **Mechanisms for escalating reviews of deteriorating or problem credits (for example, watch lists).**

How has removal of reliance upon ratings changed examiner expectations for due diligence on securities? (continued)

Possible Examiner Action:

- **To ensure that banks are able to comply with the new standards, examiners have been informing our banks about the guidance and encouraging bankers to begin updating policies and recommend policy changes, where appropriate.**

- **Relative to the new guidance, violations may be cited relative to:**
  - **FDIC Rules and Regulations Part 362, governing permissibility, and/or**
  - **Part 364, governing safety and soundness considerations.**

OCC Guidance identifies key risk factors that banks should consider in their credit risk assessments.

Key factors	Corporate bonds	Municipal government general obligations	Revenue bonds	Structured securities
Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality	X	X	X	X
Confirm risk of default is low and consistent with bonds of similar credit quality	X	X	X	X
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	X	X	X	X
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	....	X	....	....
Understand local demographics/economics. Consider unemployment data, local employers, income indices, and home values	....	X	X	....
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	....	....	X	....
Understand the class or tranche and its relative position in the securitization structure	....	....	....	X
Assess the position in the cash flow waterfall	....	....	....	X
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	....	....	....	X
Evaluate and understand the quality of the underwriting of the underlying collateral as well as any risk concentrations	....	....	....	X
Determine whether current underwriting is consistent with the original underwriting underlying the historical performance of the collateral and consider the affect of any changes	....	....	....	X
Assess the structural subordination and determine if adequate given current underwriting standards	....	....	....	X
Analyze and understand the impact of collateral deterioration on tranche performance and potential credit losses under adverse economic conditions	....	....	....	X

FDIC article "Credit Risk Assessment of Bank Investment Portfolios" in the journal Supervisory Insights (summer 2013)

A bank may find it beneficial to grade a bond as it grades a commercial loan by assessing and scoring various factors. Cumulative scores could be generated by adding the specific scores given to each assessment factor.

XYZ MUNICIPALITY	
Credit Factor	**Factor Score (1-5)**
Health of Local Economy (Per Capita Income, Population Growth, Unemployment Rate, etc.)	
Location in Low-Risk State or Region	
Current Financial Statements	
Budget Performance	
Degree of Tax Burden	
Level of Debt and Unfunded Liabilities	
Payment Performance	
Credit Enhancement	
Spreads Comparable to Similar Bonds	
NRSRO Rating	
Cumulative Score	

Many sources of information exist for conducting bond credit analyses at little or low cost.

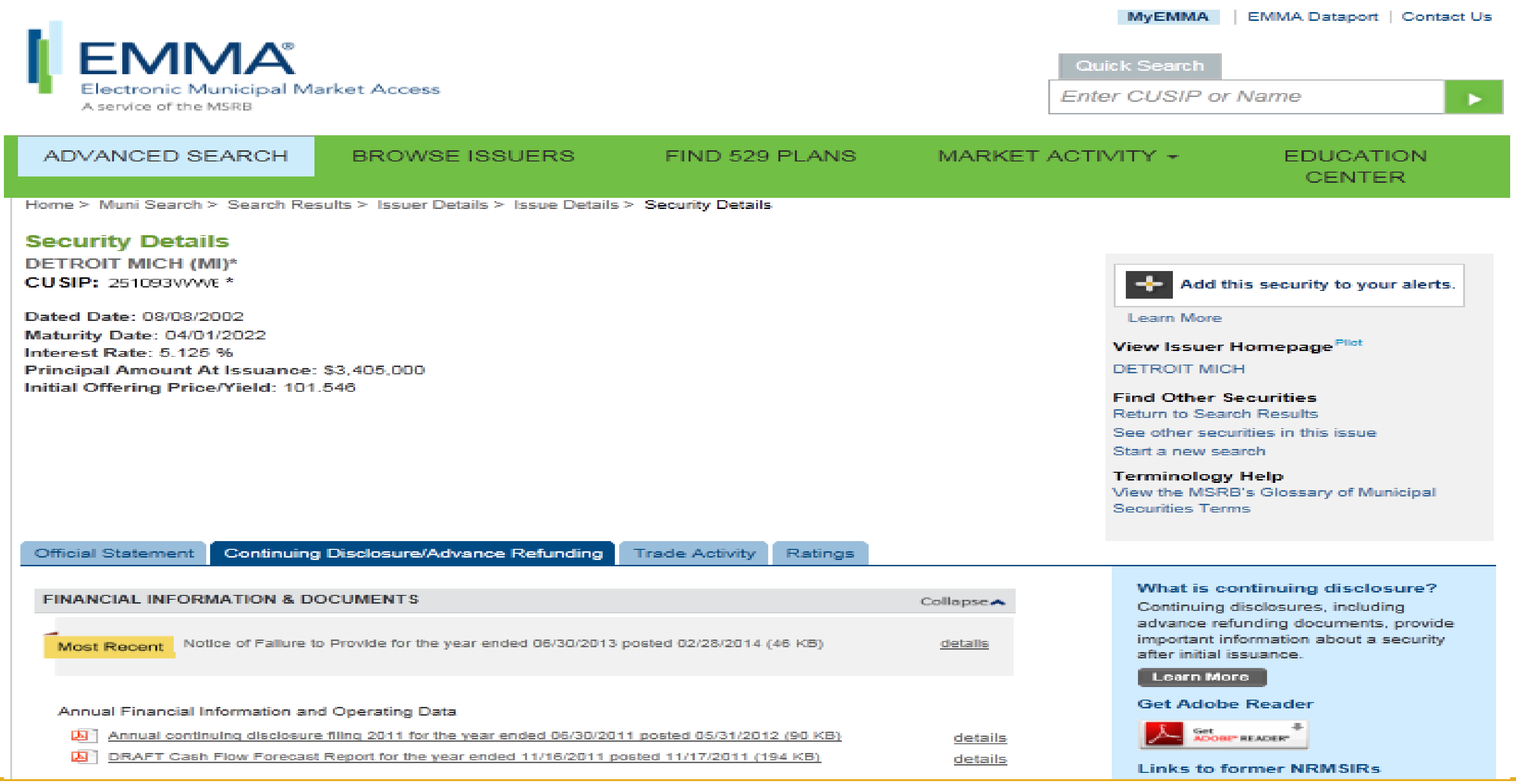
Banks do not necessarily need high cost systems, like Bloomberg, CreditSights or subscription services.

- For example, for municipal bonds:

Primary Credit Metrics	Secondary Credit Metrics	Market Data and Comparables
• EMMA • Broker-provided Official Statements and issuer analytics • Direct issuer requests	• Econdata.net • Bureau of Economic Analysis (BEA.gov) • Bureau of Labor Statistics (BLS.gov) • Census Bureau (census.gov) • FDIC Recon Data	• Sifma.org • EMMA • Finra.org • Broker-provided trade statistics & comps

Credit Due Diligence

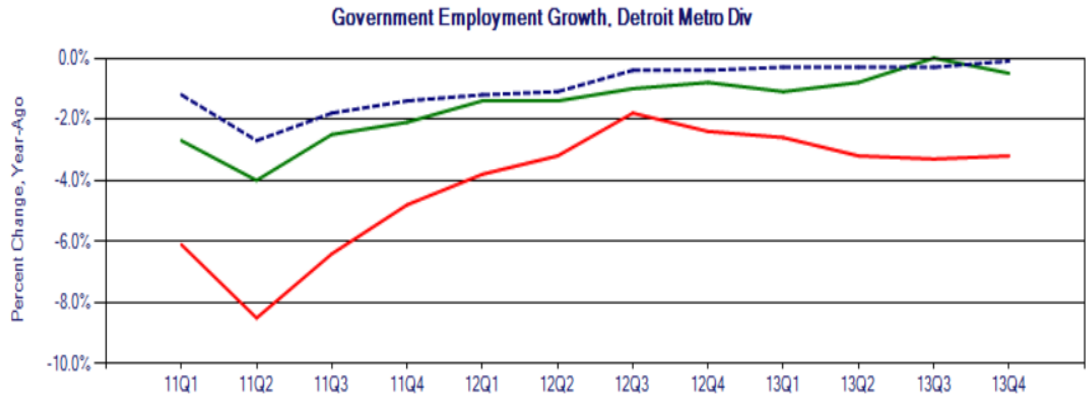
Continuing with the example of municipal bonds, official statements and financial performance updates are available for free at the EMMA site.



Regional Economic Data

The FDIC site RECON http://www2.fdic.gov/RECON/ReconInternet/Index offers information about regional economic conditions.

Government Employment Growth



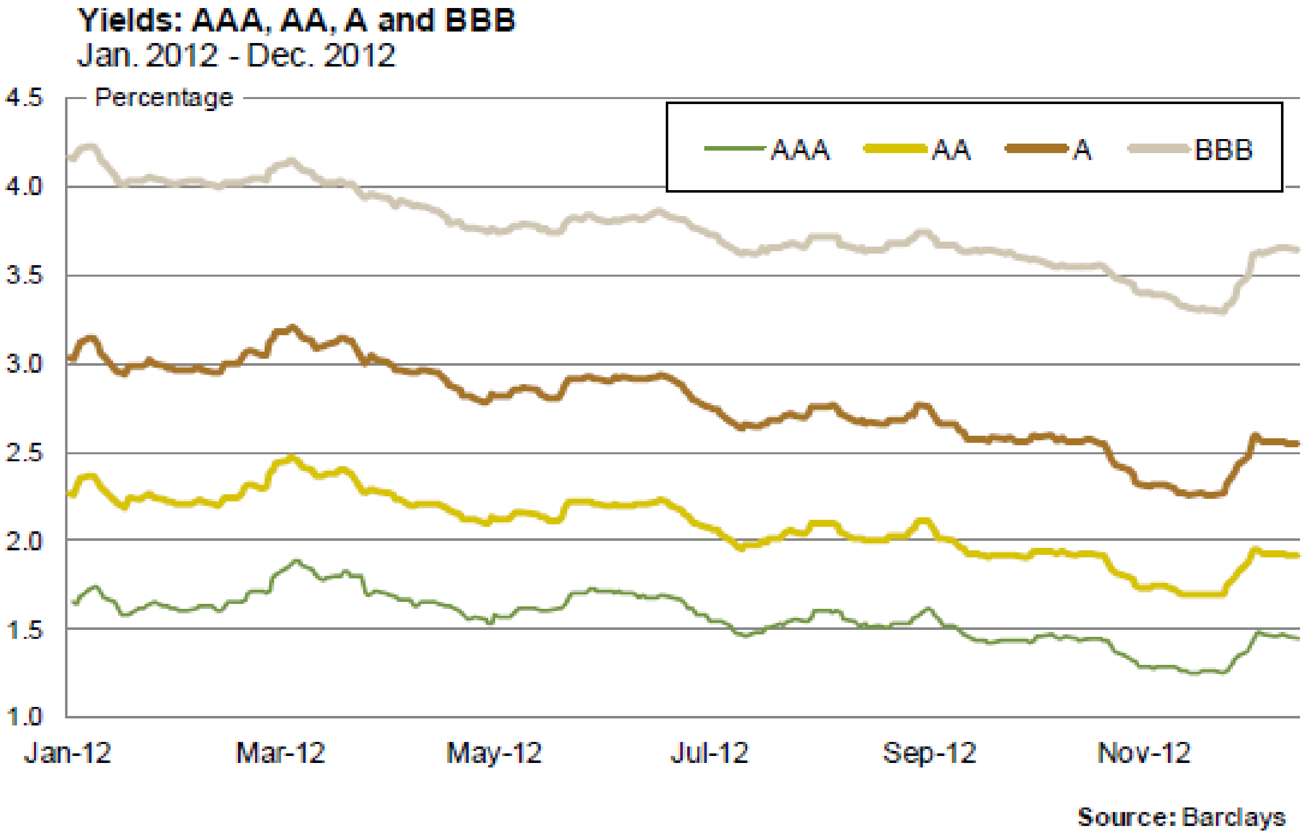
	11Q1	11Q2	11Q3	11Q4	12Q1	12Q2	12Q3	12Q4	13Q1	13Q2	13Q3	13Q4
United States (NSA)	-1.2%	-2.7%	-1.8%	-1.4%	-1.2%	-1.1%	-0.4%	-0.4%	-0.3%	-0.3%	-0.3%	-0.1%
Michigan (NSA)	-2.7%	-4.0%	-2.5%	-2.1%	-1.4%	-1.4%	-1.0%	-0.8%	-1.1%	-0.8%	0.0%	-0.5%
Detroit Metro Div (NSA)	-6.1%	-8.5%	-6.4%	-4.8%	-3.8%	-3.2%	-1.8%	-2.4%	-2.6%	-3.2%	-3.3%	-3.2%

NSA = Not Seasonally Adjusted

Source: Bureau of Labor Statistics (Haver Analytics) Data Updated 1/28/2014

Credit Due Diligence

Comparative spread data is often available on-line for free from SIFMA.org.



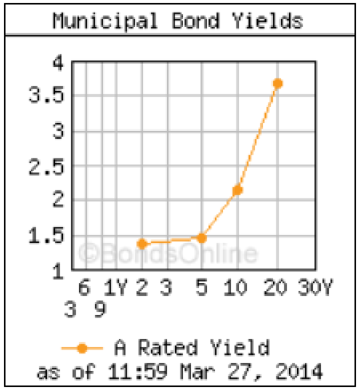
Credit Due Diligence

Comparative spread data is often available on-line for free from private vendors.

Municipal Bonds (11:59 ET March 27, 14) Historical Data

Maturity	Yield	Yesterday	Last Week	Last Month	Yield Change	TEY* (28%)	Spread
2yr AAA	0.38	0.41	0.35	0.31	-0.02	0.53	0.14
2yr AA	0.44	0.43	0.47	0.39	-0.02	0.61	0.22
2yr A	1.38	1.32	1.41	0.56	0.09	1.92	1.53
5yr AAA	1.24	1.23	1.13	1.08	-0.01	1.72	0.05
5yr AA	1.37	1.37	1.25	1.22	0.00	1.90	0.23
5yr A	1.47	1.48	1.43	1.35	-0.02	2.04	0.37
10yr AAA	2.39	2.48	2.43	1.78	0.02	3.32	0.67
10yr AA	2.47	2.46	2.38	2.60	0.00	3.43	0.78
10yr A	2.15	2.04	1.99	2.39	0.13	2.99	0.34
20yr AAA	3.00	3.15	3.41	4.08	-0.11	4.17	-
20yr AA	3.79	3.80	3.80	4.09	0.02	5.26	-
20yr A	3.67	3.79	3.67	4.14	-0.04	5.10	-

* Tax Equivalent Yield for 28% Federal Income Tax.



Source: www.bondsonline.com

Some strategies to manage securities holdings in the context of this new guidance are available.

- **At a minimum, bankers may want to use credit agency ratings in their credit reviews, along with a fundamental issuer capacity-to-pay analysis.**

  In a more robust system, credit reviews could consider the full suite of risk factors, related to a bond, including extensive use of market comparisons and economic/sector trend data.

- **Bankers may want to monitor performance at the portfolio or sector level, with detailed credit analysis updated at least annually for larger risk exposures.**

  In a best practices system, bankers could fully update credit analyses at least annually for all obligors and transactions.

Some strategies to manage securities holdings in the context of this new guidance are available.

- **Bankers may want to scale the depth of their credit reviews to the level of risk, complexity, and exposure involved.**

  Ideally, a banker could apply a full internal credit rating system to all obligors and credits.

- **Bankers may wish an investment policy that includes concentration limits, relative to, for example, obligor, sector, collateral type, and product type.**

  Even better, a bank investment policy could include concentration limits related to additional key risk factors, like issuer credit ratios or maturity term.

Strategies to manage securities holdings in the context of this new guidance are available.

- **A bank may want to perform stress testing at least annually using pre-established stress scenarios and model assumptions.**

  With a very robust system, a banker could perform stress testing at least quarterly using break even analyses and more dynamic stress assumptions tied to changing economic variables.

Uniform Agreement on the Classification and Appraisal of Securities October 29, 2013 FDIC FIL-51-2013

- **FDIC examiners will use the agreement to determine whether an asset should be adversely classified during supervisory reviews.**
- **Fundamental credit analysis is critical to understanding the risk associated with all assets and should be applied to investment securities as a part of a pre-purchase and ongoing due-diligence process.**
- **This joint statement replaces the 2004 Agreement and is consistent with Section 939A of the Dodd-Frank Act, which directed the agencies to remove references to credit ratings in bank regulations.**
- **State nonmember institutions are expected to perform an investment security creditworthiness assessment that does not rely solely on external credit ratings.**
- **The federal banking agencies' longstanding asset classification definitions have not changed.**

Uniform Classifications Agreement - Highlights

- **The Doubtful classification that has been used for loans is made more clearly applicable to securities.**

  A <u>Doubtful</u> classification is appropriate when an asset has experienced significant credit deterioration and decline in fair value, but estimation of impairment involves significant uncertainty because of various pending factors. These factors could include uncertain financial data that may not permit the accurate forecasting of future cash flows or estimating recovery value.

  The use of the Doubtful classification is an interim measure until information becomes available to substantiate a more appropriate treatment.

Uniform Classifications Agreement - Highlights

- **For securities already owned, where the credit condition subsequently improves, the facts and circumstances supported by current analysis may warrant an upgrade to “pass.”**
  - ***An upgrade is only appropriate following a period of sustained performance. If the security incurs credit losses, but subsequent analysis shows that all future contractual payments will be received, the security may warrant an upgrade to “pass.”***

Uniform Classifications Agreement - Highlights

- **Depository institutions may <u>not purchase</u> investment securities that fail to meet the investment grade standard as defined by applicable regulations.**
  - **If pre-purchase analysis reveals previous credit losses in a[n existing] security under consideration, regardless of its current performance or projected payment analysis, the security does not, and cannot, meet the investment grade standard.**
  - **In contrast, if a security experienced credit deterioration and downgrades in the past [or was restructured], but did not sustain actual credit losses, the security's current and projected payment performance may indicate that the security could meet the investment grade criteria once more. If it is offered for sale at this point and has a history of sustained performance, this security would be considered eligible for purchase by a depository institution.**

The federal banking agencies' longstanding asset classification definitions have not changed.

- A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

- An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

- Assets classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.

References

- **Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA), Section 939A.**
- **For the OCC's final rules, see 77 Fed. Reg. 35253 (June 13, 2012). For the OCC's guidance, see 77 Fed. Reg. 35259 (June 13, 2012) and OCC Bulletin 2012-18 and OCC Bulletin 2012-26.**
- ***Revised Standards of Creditworthiness for Investment Securities*, issued as FIL 48-2012.**
- **Supervisory Policy Statement on Investment Securities & End-User Derivatives Activities, issued on April 28, 1998 as FIL-45-98.**
- **Uniform Agreement on the Classification and Appraisal of Securities, issued on October 29, 2013 as FIL-51-2013.**

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Questions?