

Federal Deposit Insurance Corporation
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- **12 CFR Part 362**
- **Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security Is Eligible for Investment**

Dear Sir,

Thank you for giving us the opportunity to comment on your proposed Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security Is Eligible for Investment.

You are seeking comment on proposed guidance that would assist savings associations in conducting due diligence to determine whether a corporate debt security is eligible for investment under a recently proposed rule¹. I have commented separately on the proposed rule, and my comments here are in addition to those.

I agree with much of the proposed guidance, in particular the following important points:

- savings associations should conduct an appropriate level of due diligence in determining whether a corporate debt security is eligible for investment under proposed 12 CFR 362.11(b)
- the depth of the due diligence should be a function of the security's credit quality, the complexity of the issuer's financial structure, and the size of the investment
- management should ensure they understand the security's structure and how the security will perform in various scenarios throughout the business cycle
- savings associations should have in place an appropriate risk management framework for the level of risk in their corporate debt investment portfolios

¹ See Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities, FDIC, 76 FR 78086 (December 15, 2011).

- irrespective of any contractual or other arrangements, savings associations are responsible for understanding and managing the risks of all of their investments.

However, I would recommend that more emphasis should be given to the importance of stress testing in order to understand the credit risk of a corporate debt security, and the nature, amount, timing and uncertainty of repayments of principal and interest. This should be done on a security level and a portfolio level for completeness.

Naturally stress testing should allow for shocks and variations along the following lines:

- 1) changing individual assumptions and parameters (sensitivity testing);
- 2) changing several assumptions and parameters at the same time, where the assumptions and parameters could reasonably be expected to change together (scenario testing);
- 3) changing the dependencies assumed between assumptions and parameters.

Simplified stress testing would focus on default rates and direct estimates of loss given default. More complex stress testing would stress individual economic or demographic assumptions, and combinations thereon (scenarios), in order to develop their impact on the nature, amount, timing and uncertainty of repayments of principal and interest. The potential losses (or values at risk) from stress testing should provide key input for the due diligence of a corporate security in order to determine its creditworthiness.

The proposed guidance also refers to risk tolerance, stating that: "A key role for management in the oversight process is to translate the risk tolerance levels established by the board of directors into a set of internal operating policies and procedures that govern the institution's investment activities". This guidance seems to refer specifically to credit risk concentration limits. However, we should be clear that an entity's own risk tolerance levels should not bear upon the due diligence of a corporate security, or the determination of its creditworthiness, otherwise the determination would be entity-specific and we would violate one of the key objectives of a creditworthiness standard: that it should allow different banks or savings associations to assign the same or similar assessment of credit quality to the same or similar credit exposures.

Yours faithfully

C.R.B.

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