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Guidance on Investment Securities Practices

The Comptroller of the Currency (the "OCC") published today its final guidance (the "Guidance") on the regulatory expectations with regard to investing in investment securities and any ongoing portfolio due diligence activities

<u>When is this Guidance Effective?</u>

Next January 1. But banks have to insure that their existing portfolios of investment securities meet the new standards by that date. Banks have to demonstrate that their investment securities meet the credit quality standards of 12 CFR Part 1. Bank examinations occurring in 2013 will test whether the Guidance is being followed.

<u>Is this part of Dodd-Frank?</u>

Yes, Dodd Frank required the agencies to review any regulations that require that use of an assessment of the creditworthiness of a security and any references to credit ratings. The agencies have to amend their regulations to remove any references to credit ratings and put in other standards that the agencies think are appropriate.

<u>What needs to be done to respond to this Guidance?</u>

The OCC thinks that banks that have not relied excessively on credit ratings when making investment decisions will not have to do very much. However, all investment security policies and procedures need to be scrubbed to remove references to credit ratings or the bank will be criticized at examination time. Policies need to be checked to insure that pre and post investment reviews are conducted. The scope of credit analysis suggested in any policies should be vetted against the size and complexity of the security portfolio and the credit and risk committees or the Board should give final blessing to the revamped policy and procedures.

What are the important changes?

The definition of ''investment grade'' in 12 CFR part 1has been amended to no longer reference credit ratings. Instead, ''investment grade'' securities would be 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.

What do Banks have to do before purchasing an Investment Security?

Determine whether it is "investment grade" and insure that internal policies and procedures have been followed

How doe the Guidance apply to Investments in Government Securities?

Government obligations are not subject to the "investment grade" criteria. This includes Treasuries, agencies, municipal general obligations and perhaps municipal revenue bonds. At all times, safety and soundness considerations apply and all investments should be measured against investment policies of the bank.
Municipal bonds should be subject to a credit analysis and then an ongoing review based on risk characteristics.

What Credit Analysis should be made on Investment Securities?

The same fundamental credit analysis that applies to the loan portfolio applies to investment securities. A bank should do enough due diligence to support its opinion that a security is investment grade. This research may be delegated, but not the responsibility for the investment decision. The degree of diligence depends on the complexity of the security and the size of the investment. Structured securities require special attention.

What are the ongoing Risk Management Requirements?

The OCC has long required that banks have risk management processes to manage risk in an investment portfolio. The OCC has supplemented its recommended procedures in view of the recent and perhaps ongoing market disruptions. At a minimum there must be a portfolio risk management process to understand the key portfolio risks. There must be internal operating policies and procedures to govern investment activities. The policies need to be mapped to the bank business, capital and expertise. Each investment needs to be evaluated prior to purchase and periodically thereafter. A key component is concentration risk. An outside third party may conduct the ongoing review.