security for the projected life of the investment.

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Dated at Washington, DC, this 7th day of December 2011.

By order of the Board of Directors.
Federal Deposit Insurance Corporation.

Robert E. Feldman,
Executive Secretary.

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determines, prior to acquiring the security and periodically thereafter, that the issuer has adequate capacity to satisfy all financial commitments under the security for the projected life of the investment. An issuer satisfies this requirement if, based on the assessment of the savings association, the issuer presents a low risk of default and is likely to make full and timely repayment of principal and interest. The investment also must be consistent with safe and sound banking practices.

Background

Part 362 of the FDIC's regulations sets forth the requirements for determining whether securities have appropriate credit quality and marketability characteristics to be purchased and held by insured savings associations. Under section 362.11(b), a savings association may acquire or retain a corporate debt security only if the issuer has adequate capacity to satisfy all financial commitments under the security for the projected life of the investment. An issuer satisfies this requirement if, based on the assessment of the savings association, the issuer presents a low risk of default and is likely to make full and timely repayment of principal and interest.

Savings associations must be able to demonstrate that their investment securities meet applicable credit quality standards. This Guidance sets forth criteria that savings associations should consider when conducting due diligence prior to purchasing a specific investment. The FDIC expects savings associations to conduct an appropriate level of due diligence in determining whether a corporate debt security is eligible for investment under part 362.11(b). This may include consideration of internal analyses, third-party research and analytics, including internal risk rating, external credit ratings, default statistics, and other sources of information appropriate for the particular security. 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. As an issuer's financial structure becomes more complex, the more credit-related due diligence an institution should perform, even when the credit quality is perceived to be very high. Management should ensure they understand the security’s structure and how the security will perform in various scenarios throughout the business cycle. The FDIC expects 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 security. As a general matter, a savings association will have a greater burden to support its determination if one factor is contradicted by a finding under another factor.

Although part 362 does not provide specific investment quality requirements, savings associations should conduct an appropriate level of due diligence prior to purchasing a corporate debt security to ensure that it is eligible for investment under part 362. A savings association should review and update this analysis periodically, as appropriate for size and risk profile of the security. By way of example, appropriate factors a savings association should consider include, but should not be limited to, the following:

- Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality;
- Confirm risk of default is low and consistent with bonds of similar credit quality;
- Confirm capacity to pay through internal credit analysis that can be supplemented with other third-party analytics;
- Understand applicable market demographics/economics; and
- Understand current levels and trends in operating margins, operating efficiency, profitability, return on assets and return on equity.

Maintaining an Appropriate and Effective Portfolio Risk Management Framework

Savings associations should have in place an appropriate risk management framework for the level of risk in their corporate debt 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. Savings associations should conform to safe and sound banking practices and, similarly, should consider appropriate investment portfolio risks in connection with the acquisition of a corporate debt security.3

Having a strong and robust risk management framework appropriate for the level of risk of a savings association’s investment portfolio is particularly critical for managing portfolio credit risk. 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. Specifically, investment policies 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. Savings associations with investment portfolios that lack diversification in one of the aforementioned areas should enhance their monitoring and reporting systems. Safety and soundness principles warrant effective concentration risk management programs to ensure that credit exposures do not reach an excessive level.

1 See supra footnote 1.


3 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.
Savings associations should identify and measure the risks of their investments periodically after acquisition. Such analyses allow an institution to understand and effectively manage the risks of its investment portfolio, including credit risk, and are an essential element of a sound investment portfolio risk management framework. Exposure to each type of risk for each security should be measured and aggregated with similar exposures on an institution-wide basis. Risk measurement should be obtained from sources independent of sellers or counterparties and should be periodically validated. Irrespective of any contractual or other arrangements, savings associations are responsible for understanding and managing the risks of all of their investments.

Request for Comment

The FDIC requests comment on all aspects of this proposed guidance. Specifically, the FDIC is seeking commenters’ views on the following:

1. Does the proposed guidance sufficiently assist savings associations in meeting their due diligence requirements? How could the guidance be improved?

2. Should the guidance provide differentiation based on the size and scope of operations of a savings associations, specifically with respect to the factors a savings association should consider in conducting due diligence to determine the credit quality of a corporate debt security?

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