Determine Whether Securities Are Permissible Prior to Purchase

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 12 CFR 362.11(b). This may include consideration of internal analyses, third-party research and analytics including internal risk ratings, 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 the 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 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.\r

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.

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.

By order of the Board of Directors.

Dated at Washington, DC, this 18th day of July, 2012.

Robert E. Feldman,
Executive Secretary.

\footnotetext[1]{See supra footnote 1.}

\footnotetext[2]{See supra footnote 1.}
List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Correction of Publication

Accordingly, 26 CFR part 301 is corrected by making the following correcting amendment:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 301.7701–2T [Corrected]

Paragraph 2. Section 301.7701–2T is revised to read as follows:

§ 301.7701–2T Business entities; definitions (temporary).

(a) Through (c)(2)(iv) [Reserved]. For further guidance, see § 301.7701–2(a)
through (c)(2)(iv).

(A) In general. Section 301.7701–2(c)(2)(i) (relating to certain wholly
owned entities) does not apply to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24 and 25 of the Internal Revenue Code). However, § 301.7701–2(c)(2)(i) does apply to withholding requirements imposed under section 3406 (backup withholding). The owner of a business entity that is disregarded under § 301.7701–2 is subject to the withholding requirements imposed under section 3406 (backup withholding). Section 301.7701–2(c)(2)(i) also applies to taxes imposed under Subtitle A, including Chapter 2—Tax on Self Employment Income. The owner of an entity that is treated in the same manner as a sole proprietorship under § 301.7701–2(a) will be subject to tax on self-employment income.

(B) [Reserved]. For further guidance, see § 301.7701–2(c)(2)(iv)(B).

(C) Exceptions. For exceptions to the rule in § 301.7701–2(c)(2)(iv)(B), see sections 31.3121(b)(3)(1)(d), 31.3127–
1(c), and 31.3306(c)(5)(1)(d).

(D) through (c)(2)(v) [Reserved]. For further guidance, see § 301.7701–2(c)(2)(iv)(D) through (c)(2)(v).

(vi) Tax liabilities with respect to the indoor tanning services excise tax—(A) In general. Notwithstanding any other provision of § 301.7701–2, § 301.7701–2(c)(2)(i) (relating to certain wholly owned entities) does not apply for purposes of—

(1) Federal tax liabilities imposed by Chapter 49 of the Internal Revenue Code;

(2) Collection of tax imposed by Chapter 49 of the Internal Revenue Code; and

(3) Claims of a credit or refund related to the tax imposed by Chapter 49 of the Internal Revenue Code.

(B) Treatment of entity. An entity that is disregarded as an entity separate from its owner for any purpose under § 301.7701–2 is treated as a corporation with respect to items described in paragraph (c)(2)(v)(A) of this section.

(d) through (e)(4) [Reserved]. For further guidance, see § 301.7701–2(d) through (e)(4).

(5) Paragraphs (c)(2)(iv)(A) and (c)(2)(iv)(C) of this section apply to wages paid on or after November 1, 2011. For rules that apply to paragraph (c)(2)(iv)(A) of this section before November 1, 2011, see 26 CFR part 301 revised as of April 1, 2009. However, taxpayers may apply paragraphs (c)(2)(iv)(A) and (c)(2)(iv)(C) of this section to wages paid on or after January 1, 2009.

(e)(6) through (o)(7) [Reserved]. For further guidance, see § 301.7701–2(e)(6) and (o)(7).

(8) Expiration date. The applicability of paragraphs (c)(2)(iv)(A) and
(c)(2)(iv)(C) of this section expires on or before October 31, 2014.

(9) Indoor tanning services excise tax—(i) Effective/applicability date. Paragraph (c)(2)(vi) of this section applies to taxes imposed on amounts paid on or after July 1, 2012.

(ii) Expiration date. The applicability of paragraph (c)(2)(vi) of this section expires on or before June 22, 2015.

LaNita Van Dyke.

Chief, Publications and Regulations Branch, Legal Policy Division, Associate Chief Counsel (Procedure and Administration).

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