



**BOARD OF GOVERNORS**  
OF THE  
**FEDERAL RESERVE SYSTEM**

WASHINGTON, D.C. 20551

DIVISION OF BANKING  
SUPERVISION AND REGULATION

**SR 12-15**

**November 15, 2012**

**TO THE OFFICER IN CHARGE OF SUPERVISION  
AT EACH FEDERAL RESERVE BANK**

**SUBJECT: Investing in Securities without Reliance on Nationally Recognized Statistical  
Rating Organization Ratings**

**Applicability to Community Banking Organizations:** This guidance applies to all state member banks, including those with \$10 billion or less in consolidated assets.

The Federal Reserve is issuing this letter to advise state member banks that effective January 1, 2013, they may no longer rely solely on credit ratings issued by nationally recognized statistical rating organizations (external credit ratings) to determine whether a particular security is an “investment security” that is permissible for investment by a state member bank. Under regulations of the Office of the Comptroller of the Currency (OCC), securities qualify for investment by national banks only if they are determined by the bank to be “investment grade” and not predominantly speculative in nature. This letter provides background on recent statutory changes and actions of the OCC to amend its regulation on investment securities, which also applies to state member banks.

Under the Federal Reserve Act (12 USC 335) and the Federal Reserve’s Regulation H (12 CFR 208.21), state member banks are subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as national banks under the National Banking Act (12 USC 24 (Seventh)). Therefore, when investing in securities, state member banks must comply with the provisions of the National Banking Act and the OCC regulations in 12 CFR part 1. In addition to this federal requirement, a state member bank may purchase, sell, underwrite, or hold securities and stock only to the extent permitted under applicable state law.

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires each federal agency to remove references to, and requirements of reliance on, external credit ratings in any regulation issued by the agency that requires the assessment of the creditworthiness of a security or money market instrument. The agencies also are required to

substitute an alternative standard of creditworthiness.<sup>1</sup> Pursuant to this requirement, the OCC published a final rule and guidance on June 13, 2012, that revises 12 CFR part 1 by removing references to external credit ratings and generally requiring national banks to make assessments of a security's creditworthiness to determine if it is "investment grade."<sup>2</sup> This requirement is similar to existing OCC standards for the purchase of unrated securities by national banks. The final rule is effective January 1, 2013 for existing and future national bank holdings of investment securities.

Under the revised rule, a security meets the "investment grade" test only if the issuer has an adequate capacity to meet its financial commitments under the security for the projected life of the asset or exposure. Under this definition, the issuer has an adequate capacity to meet financial commitments if (1) the risk of default by the obligor is low and (2) the full and timely repayment of principal and interest is expected.<sup>3</sup> As explained in the *Federal Register* publication of the final rule, the OCC expects national banks to consider a number of factors, to the extent appropriate in making this determination. While a national bank may continue to take into account external credit ratings and assessments as a valuable source of information, the bank is expected to supplement these ratings with a degree of due diligence processes and additional analyses appropriate for the bank's risk profile and for the size and complexity of the instrument.<sup>4</sup>

Concurrent with the final rule, the OCC published final guidance, also effective January 1, 2013 (OCC investment guidance), to clarify regulatory expectations with respect to investment purchase decisions and ongoing portfolio due diligence processes. The guidance, which is attached, clarifies that generally, investment securities are expected to have good to very strong credit quality. In the case of structured securities, this determination may be influenced more by the quality of the underlying collateral, the cash flow rules, and the structure of the security itself than by the condition of the issuer.

The OCC also expects national banks to conduct an appropriate level of due diligence to understand the inherent risks of a security and determine that it is a permissible investment. The extent of the due diligence should be sufficient to support the institution's conclusion that a security meets the "investment-grade" standards. 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. Third-party analytics may be part of this analysis, although the national bank's management remains responsible for the investment decision and should ensure that prospective third parties are independent, reliable, and qualified. The guidance also sets forth an expectation that the board of directors should oversee management to make sure appropriate decision-making processes are in place.<sup>5</sup>

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<sup>1</sup> See 15 USC 78o-7, note.

<sup>2</sup> For the OCC's final rules, see 77 FR 35253 (June 13, 2012). For the OCC's guidance, see 77 FR 35259 (June 13, 2012) and OCC Bulletin 2012-18 (June 26, 2012).

<sup>3</sup> See 77 FR 35257 (June 13, 2012).

<sup>4</sup> See 77 FR 35254 (June 13, 2012).

<sup>5</sup> See 77 FR 35259 (June 13, 2012).

Investment in securities and stock by state member banks are required under the Federal Reserve Act and Regulation H to comply with the revised 12 CFR part 1 and should also meet the supervisory expectations set forth in the OCC investment guidance and this guidance. In addition, state member banks are expected to continue to meet long-established supervisory expectations for risk-management processes to ensure that the credit risk of the bank, including the credit risk of the investment portfolio, is effectively identified, measured, monitored, and controlled. As noted above, investments by state member banks must also comply with applicable state law.

Many of these expectations are set forth in the 1998 interagency *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities* (SR letter 98-12, “FFIEC Policy Statement on Investment Securities and End-User Derivatives Activities”), which provides risk-management standards for the securities investment activities of banks and savings associations. SR 98-12 emphasizes the importance of an institution conducting a thorough credit-risk analysis before and periodically after the acquisition of a security. Such analysis would allow an institution to understand and effectively manage the risks within its investment portfolio, including credit risk, and is an essential element of a sound investment portfolio risk-management framework. The supervisory expectations set forth in SR 98-12 provide criteria that institutions can use in meeting the requirements of 12 CFR part 1, and state member banks should use the expectations set forth in that guidance with respect to investing in nonrated securities when determining to invest in any security.

Reserve Banks are asked to distribute this letter to state member banks supervised by the Federal Reserve in their districts, as well as to their own application, supervisory, and examination staff. Questions regarding the attached guidance should be addressed to the following staff in the Credit, Market & Liquidity Risk Policy section: Christopher McBride, Senior Supervisory Financial Analyst, at (202) 452-3814; or Mary Aiken, Manager, at (202) 721-4534. In addition, questions may be sent via the Board’s public website.<sup>6</sup>

Michael S. Gibson  
Director

**Cross-reference:**

- SR Letter 98-12, “FFIEC Policy Statement on Investment Securities and End-User Derivatives Activities”

**Attachment:**

- *OCC Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment*

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<sup>6</sup> See <http://www.federalreserve.gov/apps/contactus/feedback.aspx>.