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CONFERENCE OF STATE BANK SUPERVISORS

Municipal Bond Job Aid

A job aid for state bank examiners providing resources and information to more thoroughly understand and analyze municipal bond debt held by depository institutions.

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Purpose

This document was developed by the State Examiner Review Team (SERT) with the intent of consolidating the guidance that has been issued by the various federal agencies in this area. In addition, some methods for analyzing municipal securities are presented to demonstrate the alternatives that are available for banks and examiners when it comes to analyzing municipal credit securities.

Background

Regulations defining what types of investment securities may be purchased by banks are typically issued by the chartering agency. For national banks under the supervision of the Office of the Comptroller of the Currency (OCC), the applicable statute is 12 CFR 1 – Investment Securities. For state-chartered banks, statutory guidance will vary by state. Some states have specific investment statutes, while others either adopt or reference the requirements of 12 CFR 1. Some states also have statutes that allow state-chartered banks to invest in any security that is acceptable for a national bank. Such statutes are often known as wildcard or parity statutes.

While the OCC's rule and guidance apply specifically to national banks, it is critical to note the Federal Reserve Act (12 USC 335) and the Federal Reserve's (FRB) Regulation H (12 CFR 208.21), along with part 362 of the Federal Deposit Insurance Corporation's (FDIC) regulations, prohibit insured state banks and their subsidiaries from engaging in investments that are not permissible for national banks and their subsidiaries under OCC regulations.

Historically, most investment securities were required to be rated investment grade, which usually meant that an investment's credit rating was within one of the four highest rating categories from a Nationally Recognized Statistical Rating Organization (NRSRO). However, this standard has changed with the passage of the Dodd Frank Wall Street and Consumer Protection Act (Dodd-Frank Act) and implementation of resulting regulatory changes.

RECENT CHANGES—THE IMPACT OF THE DODD-FRANK ACT

The traditional definition of investment grade was changed through Section 939A of the Dodd-Frank Act. Specifically, this section of the act directed all federal agencies to:

- Review any regulation that requires the use of an external rating for the assessment of creditworthiness of a security or money market instrument.
- Remove references to, or requirements for reliance on, external credit ratings from NRSROs.
- Develop a standard of creditworthiness based on factors other than NRSRO ratings.

It is important to note that no guidance issued by the federal agencies prohibits bank management's use of NRSRO ratings as *part* of their analysis. However, bank management and examiners should not unduly rely on credit ratings as the basis for their investment analysis and purchases.

Additional background about the changes resulting from Dodd-Frank:

In response to Section 939A of Dodd-Frank the OCC proposed a rule in November 2011 that eliminated the reference to credit ratings in its standard for investment grade securities and replaced it with a new definition of the term "investment grade." In June 2012, the OCC released the final rule, which adopted the proposed rule as proposed. Except for U.S. government securities and certain municipal securities, the OCC's investment securities regulations generally require a national bank to determine whether or not a security meets the definition of investment grade in order to determine whether purchasing the security is permissible. Under the final rule, investment grade securities will 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 the 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.

In addition to regulatory provisions that generally limit national banks to purchasing securities that meet the definition of investment grade, OCC regulations require that national banks conduct their investment activities in a manner that is consistent with safe and sound practices. Specifically, national banks must consider the interest rate, credit, liquidity, price and other risks presented by investments, and the investments must be appropriate for the particular institution. Fundamentally, banks should not purchase securities for which they do not understand the relevant risks.

The OCC has also finalized guidance clarifying steps national banks should take to demonstrate investment purchases, meet the newly established credit quality standards, due diligence requirements when purchasing investment securities are met, and ongoing reviews of the investment portfolio are conducted. The guidance maintains that to meet the definition of investment grade, a national bank must be able to determine that an investment security has (1) a low risk of default by the obligor, and (2) the full and timely repayment of principal and interest is expected over the expected life of the investment. The OCC expects national banks to conduct an appropriate level of due diligence to determine if an investment security is a permissible investment. This may include consideration of internal analyses, third party research and analytics including external credit ratings, internal risk ratings, default statistics, and other sources of information as 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 structure, and the size of the investment. Therefore, a national bank can incorporate credit rating agency assessments in its due diligence, but it must do more to demonstrate the permissibility of an investment.

Applicability to state-chartered institutions

While the OCC's rule and guidance apply specifically to national banks, it is critical to remember the FRB and FDIC's baseline interpretation of what is investment grade for state banks is dependent upon the OCC's final rule. Appendix A outlines an article released by the FDIC in its summer 2013 Supervisory Insights Journal explaining its perspective on the new standards and the impact on the examination process.

Finally, Dodd-Frank gave the FDIC rule-writing authority in this area for savings associations. The FDIC issued a final rule and guidance for savings associations on this topic, both of which are very similar to the OCC's rules for national banks.

FEDERAL GUIDANCE AND RULEMAKING REFERENCES

- Section 939A of the Dodd-Frank Act
- Code of Federal Regulations 12 CFR 1 – Investment Securities
- OCC Bulletin 2012-18, Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, Issue Date: June 26, 2012
- OCC Guidance on Due Diligence Requirements in Determining Whether Securities are Eligible for Investment, Issue Date: June 13, 2012
- FDIC Financial Institution Letter 20-2009, Risk Management of Investments in Structured Credit Products, Issue Date: April 30, 2009
- FDIC Financial Institution Letter 48-2012, Revised Standards of Creditworthiness for Investment Securities
- FFIEC Policy Statement on Investment Securities and End-User Derivatives Activities (1998) per FDIC Financial Institution Letter 45-98: Issue Date: April 28, 1998
- Federal Reserve Board Supervisory Letter SR 12-15, Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings, Issue Date: November 15, 2012
- Federal Reserve Rapid Response Session: Municipal Lending: An Examiner's Perspective, January 31, 2013. Login to search for Rapid Response sessions here.

DEFINITIONS—INVESTMENT TERMS EXAMINERS SHOULD UNDERSTAND

- ***Bank-Qualified.*** Under the Tax Reform Act of 1986, in order for bonds to be qualified tax-exempt obligations, the bonds must be (i) issued by a "qualified small issuer," (ii) issued for public purposes, and (iii) designated as qualified tax-exempt obligations. A "qualified small issuer" is (with respect to bonds issued during any calendar year) an issuer that issues no more than $10 million of tax-exempt bonds during the calendar year.
- ***General Obligation Bond.*** A municipal bond backed by the credit and "taxing power" of the issuing jurisdiction rather than the revenue from a given project. General obligation bonds are issued with the belief that a municipality will be able to repay its debt obligation through taxation or revenue from projects. No assets are used as collateral.
- ***Revenue Bond.*** A municipal bond supported by the revenue from a specific project, such as a toll bridge, highway or local stadium. Revenue bonds are municipal bonds that finance income-producing projects and are secured by a specified revenue source. Typically, revenue bonds can be issued by any government agency or fund that is run in the manner of a business - those entities having both operating revenues and expenses. Revenue bonds differ from general obligation bonds that can be repaid through a variety of tax sources.
- ***Type I Security.*** A definition provided for national banks in 12 CFR 1. Type I securities include:
    - Obligations of the United States;
    - Obligations issued, insured, or guaranteed by a department or an agency of the United States Government, if the obligation, insurance, or guarantee commits the full faith and credit of the United States for the repayment of the obligation;
    - Obligations issued by a department or agency of the United States, or an agency or political subdivision of a State of the United States, that represent an interest in a loan or a pool of loans made to third parties, if the full faith and credit of the United States has been validly pledged for the full and timely payment of interest on, and principal of, the loans in the event of non-payment by the third party obligor(s);

Specific to municipal debt

    - General obligations of a State of the United States or any political subdivision thereof; and municipal bonds if the national bank is well capitalized as defined in 12 CFR 6.4(b)(1);
    - Obligations authorized under 12 U.S.C. 24 (Seventh) as permissible for a national bank to deal in, underwrite, purchase, and sell for the bank's own account, including qualified Canadian government obligations; and
    - Other securities the OCC determines to be eligible as Type I securities under 12 U.S.C. 24 (Seventh).
- **Type II Security.** A definition provided for national banks in 12 CFR 1. Type II securities include:

Specific to municipal debt

    - Obligations issued by a State, or a political subdivision or agency of a State, for housing, university, or dormitory purposes that would not satisfy the definition of Type I securities pursuant to paragraph (j) of § 1.2;
    - Obligations of international and multilateral development banks and organizations listed in 12 U.S.C. 24 (Seventh);
    - Other obligations listed in 12 U.S.C. 24 (Seventh) as permissible for a bank to deal in, underwrite, purchase, and sell for the bank's own account, subject to a limitation per obligor of 10 percent of the bank's capital and surplus; and
    - Other securities the OCC determines to be eligible as Type II securities under 12 U.S.C. 24 (Seventh).
- ***Type III Security.*** A definition provided for national banks in 12 CFR 1. Type III securities include:
    - Any investment security that does not qualify as a Type I, II, IV, or V security.

Specific to municipal debt

    - Examples of Type III securities include corporate bonds and municipal bonds that do not satisfy the definition of Type I securities pursuant to paragraph (j) of § 1.2 or the definition of Type II securities pursuant to paragraph (k) of § 1.2.

- ***Type IV Security.*** A definition provided for national banks in 12 CFR 1. Type IV securities include:
    - A small business-related security as defined in section 3(a)(53)(A) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(53)(A), that is fully secured by interests in a pool of loans to numerous obligors.
    - A commercial mortgage-related security that meets certain criteria described in 12 CFR 1
    - A residential mortgage-related security that is offered and sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5) that is investment grade, or a residential mortgage-related security that does not otherwise qualify as a Type I security.
- ***Type V Security.*** A definition provided for national banks in 12 CFR 1. Type V means a security is:
    - Investment grade;
    - Marketable;
    - Not a Type IV security; and
    - Fully secured by interests in a pool of loans to numerous obligors and in which a national bank can invest directly.

Analysis – What to consider when determining eligibility for investment

In its Guidance on Due Diligence Requirements in Determining Whether Securities are Eligible for Investment, the OCC included a matrix that listed factors to be considered in the review and purchase of investment securities. As with anything, 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.

Key factors	Corporate bonds	Municipal government general obligations	Revenue bonds	Structured securities
Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality	X	X	X	X
Confirm risk of default is low and consistent with bonds of similar credit quality	X	X	X	X
Confirm capacity to pay and assess operating and financial performance levels and trends through internal credit analysis and/or other third party analytics, as appropriate for the particular security	X	X	X	X
Evaluate the soundness of a municipal's budgetary position and stability of its tax revenues. Consider debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority, and management experience	....	X	....	....
Understand local demographics/economics. Consider unemployment data, local employers, income indices, and home values	....	X	X	....
Assess the source and strength of revenue structure for municipal authorities. Consider obligor's financial condition and reserve levels, annual debt service and debt coverage ratio, credit enhancement, legal covenants, and nature of project	....	....	X	....
Understand the class or tranche and its relative position in the securitization structure	....	....	....	X
Assess the position in the cash flow waterfall	....	....	....	X
Understand loss allocation rules, specific definition of default, the potential impact of performance and market value triggers, and support provided by credit and/or liquidity enhancements	....	....	....	X
Evaluate and understand the quality of the underwriting of the underlying collateral as well as any risk concentrations	....	....	....	X
Determine whether current underwriting is consistent with the original underwriting underlying the historical performance of the collateral and consider the affect of any changes	....	....	....	X
Assess the structural subordination and determine if adequate given current underwriting standards	....	....	....	X
Analyze and understand the impact of collateral deterioration on tranche performance and potential credit losses under adverse economic conditions	....	....	....	X

At a minimum, management should be able to document their review of a municipal obligor's:

- Balance sheet
- Operating financial statement
- Pertinent economic conditions

A municipal credit should be analyzed in a manner similar to a loan. No single metric should be viewed in a vacuum. Though a NRSRO rating may not be the *sole* basis for analysis, keep in mind that if a rating is available, there are usually narratives available to support the assigned rating. The table below highlights commonly used metrics when evaluating municipal bond obligations. These metrics are not mandatory and do not apply to all issuances.

Metric	Description	Comment
Debt to Assessed Value (or Direct Debt Burden)	Issuer's Total outstanding Bonded Debt divided by the Aggregate Tax Assessed Value for the political entity's jurisdiction	Measures the extent of debt relative to the tax base. The more leveraged the tax base, the more difficult to service the existing debt and to take on new debt.
Overall Debt to Assessed Value (or Overall Direct Debt Burden)	All Bonded Debt divided by the Aggregate Tax Assessed Value for the political entity's jurisdiction	This ratio is the same as the preceding ratio, but includes the overlapping debt of other political entities within the same taxing jurisdiction.
Direct Debt Per Capita	Issuer's Net Debt divided by the Total population of the taxable public for a particular issue.	Measures the dollar amount of debt supported by the entity's population. The more leveraged the population, the more difficult to service the existing debt and to take on new debt.
Overall Debt per Capita	All Bonded Debt divided by the Total population of the taxable public for a particular issue.	This ratio is the same as the preceding ratio, but includes the overlapping debt of other political entities within the same taxing jurisdiction.
Debt Coverage Ratio	Total Debt Service Requirements in next year divided by Available Cash and Cash Inflows	A measure of an Issuer's ability to meet short-term debt service requirements. A high coverage ratio indicates a better ability to meet the expenses in question.
General Fund Cash Balance % of Expenses	General Fund (unrestricted Cash and Cash Equivalents) divided by Expenses	Measures the financial reserves available to fund unforeseen contingencies. The higher the number, the lower the risk.
Liquidity Ratio	Total Government Cash (unrestricted Cash and Cash Equivalents) divided by Total Expenditures	Measures the available cash (liquid assets) compared with expenditures (in a sudden liquidity crunch, is the municipality prepared?) The higher the number, the lower the risk.
Debt Service Liquidity Ratio	Total Debt Service Requirements (in short-term time frames) divided by Cash and Cash Equivalents	Measures liquid asset sufficiency for the next debt service payment. The higher the number, the lower the risk.
Debt Service as a % of Operating Expenses	Total Debt Service Requirements in next year divided by Operating Expenses	Measures the amount of fixed, annual expenses dedicated to debt service. The higher the number, the higher the risk.
Debt/Financial Flexibility Ratio	Net Debt divided by Expenses	Measures the fixed-cost burden that debt places on government. A high ratio means that there is limited line-item flexibility should operations become stressed.
Top 10 Taxpayers Taxable Value as % of Total Tax Base	Total taxable value of the top ten tax-paying entities expressed as a percent of the total tax base.	A high value could expose the municipality to financial difficulties if a large taxpayer fails or departs the taxing jurisdiction.

A municipal debt obligation's quality is often dependent on the local economic conditions. Taxable bases, employment rates, and housing market strength factor in to an issuer's ability to repay an obligation. For these reasons, it is important to develop a sense of the general economic health of a region when analyzing a municipal credit. There is significant public data available, much of which can be searched by state, region, or locality. Some helpful websites and data sources are below.

General economic conditions by region/state	FDIC's Regional Economic Conditions: http://www2.fdic.gov/RECON/ReconInternet/ReconIndex Bureau of Economic Analysis: http://www.bea.gov/ Federal Reserve Bank of St. Louis: http://research.stlouisfed.org/
Housing data	FHFA's house price indices (by state): http://www.fhfa.gov/Default.aspx?Page=215
Income and wages	Bureau of Labor Statistics: http://www.bls.gov/

Other data points that may be used in developing an understanding of municipal repayment capacity are listed below. Often, this information can be found in the prospectus of each issuance.

- Dependence on State or Federal aid
- Overall taxing authority and capacity
- Unfunded pension fund obligations
- Uses of funds – for example, are bond revenues being used for an essential service or a speculative purpose such as CRE development
- Credit enhancements, such as municipal bond insurance or state guarantees such as the Texas School Trust Fund

Components of ongoing monitoring

There is no formal guidance establishing a frequency for municipal portfolio reviews. However, risk management policies, principles, and due diligence processes should be commensurate with the complexity of the investment portfolio and the materiality of the portfolio to the financial performance and capital position of the institution.[1] Holdings where current financial information is unavailable should warrant more frequent analysis. Concentrated positions should be identified and assessed in more depth and with more frequency, and any system should ensure an accurate and timely risk assessment and reporting process that informs the board of material changes to the risk profile. To help illustrate the general expectations of ongoing monitoring, and to help examiners estimate the level of risk in a municipal portfolio, the following table may be used as a methodology.

Question/consideration	YES	NO
Is current and accurate financial information readily available?		
Is current and accurate local/regional economic data readily available?		
Has the institution developed a material position or concentration in one (or more) obligor?		
Do any municipal investments fall into the categories of Type II or Type III?		
Has the board approved a policy that provides for credit risk concentration limits, limits on concentrations of a single obligor, geographical area, and those with similar characteristics?		
Does the portfolio, in aggregate, represent a concentration?		
Does management have the technical capability and expertise to manage the municipal portfolio?		

Shaded responses are meant to highlight risks that may warrant a more thorough review of management's processes, procedures, or quality of the investments.

Other points to remember:

- Management cannot delegate their responsibility for decision making and due diligence.
- If bank management does rely upon a third-party provider, those parties should be independent, qualified, and reliable.
- While it is true that many municipal obligations may be exempt from credit analysis to determine if the investment-grade standard has been satisfied, institutions will have to have a sufficient understanding of credit risk in those to meet safety and soundness standards. Supervisors will expect banks to have a sufficient understanding of the credit risk of municipals to ensure standards for safety and soundness are observed and maintained. And, as has always been the case, management should fully understand safety and soundness standards related to interest rate risk, operational risk, liquidity risk, etc.[2]

[1] http://www.gpo.gov/fdsys/pkg/FR-2012-06-13/pdf/2012-14168.pdf
[2] http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum13/SIsummer13.pdf

Impact of Bankruptcy

According to Municipal Bankruptcy: An Overview for Local Officials issued by *State Budget Solutions*[3]*:*

> Chapter 9 of the Federal Bankruptcy Code provides for the financial reorganization of municipalities, including cities, towns, villages, counties, taxing districts, municipal utilities, and school districts, facing a backlog of unpaid bills. Chapter 9 permits both general municipalities (issuers of general obligation bonds serviced by tax revenue) and certain quasi-governmental municipal authorities (issuers of special obligation bonds serviced by project revenue) to reorganize debts. Although federal law governs Chapter 9 bankruptcy, state law significantly impacts the eligibility of municipalities to file for Chapter 9 bankruptcy and the related proceedings.
>
> The purpose of filing Chapter 9 bankruptcy is to provide a financially distressed government body protection from its creditors while it reorganizes to make itself more fiscally stable. Reorganization of debts extends debt maturities, reduces the amount of principal debt or interest on the debt, and/or refinances the debt by obtaining a new loan. Chapter 9 is similar to Chapter 11, which is applicable to most private companies except banks and insurance companies, in that both provide for a mechanism of restructuring obligations under the protection of the bankruptcy court's automatic stay. This automatic stay allows municipalities to work out their finances without incurring additional debt or interest on outstanding loans.
>
> Nonetheless, Chapter 9 bankruptcies are very different from other forms of bankruptcy. In Chapter 9 bankruptcy, there is no provision for liquidation of the municipality's assets and subsequent distribution of the proceeds to creditors. Furthermore, unlike private companies, municipalities cannot simply dissolve, allowing creditors to take the value of municipal assets as compensation for their investments. Although municipalities cannot dissolve assets by filing for bankruptcy, dissolution of the municipality itself is a viable alternative. For some smaller municipalities, particularly those adjacent to larger government entities, it is feasible for a bankrupt municipality to disincorporate, pursuant to some states' laws, effectively merging with a larger municipality. Historically, disincorporation occurred when cities became "ghost towns," for instance, during the Great Depression. Today, dissolution usually occurs with smaller municipal entities, although it is an option for larger cities.
>
> Chapter 9 bankruptcies also differ with respect to the involvement of the court. In Chapter 11 corporate bankruptcy, the court is heavily involved in managing the bankruptcy and reorganization. In contrast, the court's role in Chapter 9 bankruptcy is generally limited to determining whether the municipality is eligible to file for bankruptcy under state law, approving the bankruptcy petition, confirming a debt adjustment plan, and ensuring proper implementation of the plan. A municipality may consent to more extensive court involvement in order to obtain court order protections and eliminate the need for inefficient decision-making in multiple forums-this enforcement mechanism may be used to avoid making difficult spending cuts to programs and benefits regimes.

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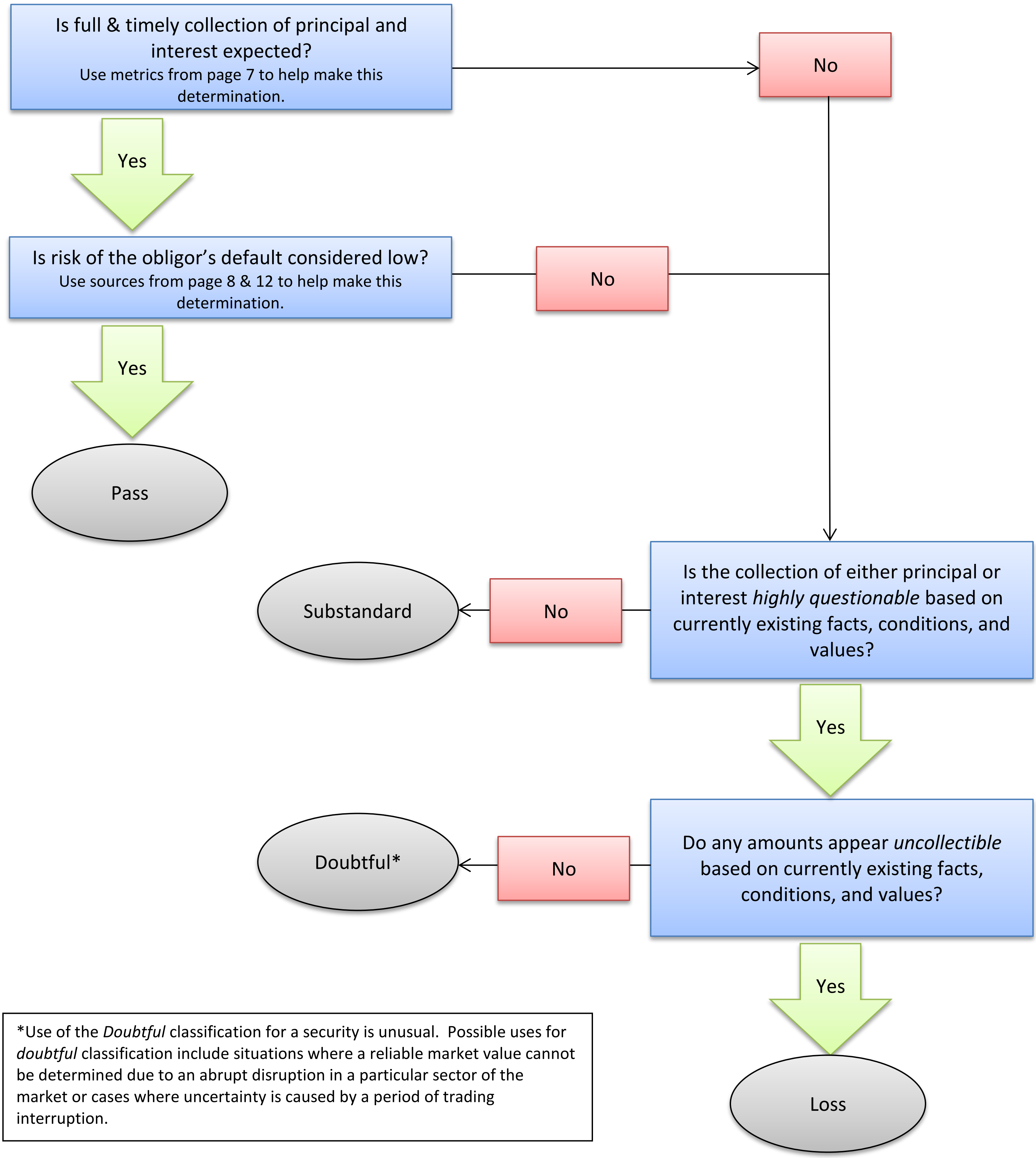
[3] http://www.statebudgetsolutions.org/doclib/20130301_SBSBankrupcyReport.pdf

Examination Treatment & Classification

The examination and classification treatment of securities is dictated by 2004 [*Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts.*]() The flowchart below highlights the considerations and sources of information examiners may use to come to an appropriate classification decision.



*Use of the *Doubtful* classification for a security is unusual. Possible uses for *doubtful* classification include situations where a reliable market value cannot be determined due to an abrupt disruption in a particular sector of the market or cases where uncertainty is caused by a period of trading interruption.

The FDIC Manual of Examination Policies references the following table for standard classification of investments.

Security Type	**Classification**		
	Substandard	***Doubtful***	***Loss***
Investment quality debt securities with "temporary" impairment	----	----	----
Investment quality debt securities with "other than temporary" impairment	----	----	Impairment
Subinvestment quality debt securities with "temporary" impairment	Amortized Cost	----	----
Subinvestment quality debt securities with "other than temporary" impairment, including defaulted debt securities.	Fair Value	----	Impairment
NOTE: Impairment is the amount by which amortized cost exceeds fair value.			

Use of the *Doubtful* classification for a security is unusual. Possible uses for *doubtful* classification include situations where a reliable market value cannot be determined due to an abrupt disruption in a particular sector of the market or cases where uncertainty is caused by a period of trading interruption.

Additional Resources

Use the following to research individual issuances and/or municipalities.

- Electronic Municipal Market Access. An official source for municipal disclosures and market data. Municipalities voluntarily disclose financial information on a regular basis.
- FDIC Securities Information Request System (SIRS) This document explains a service offered by the FDIC whereby bond information can be submitted for real-time pricing and market information.
- Financial Industry Regulatory Authority. A source for general bond market data.
- Standard and Poor's. A free account can be created to provide access to credit ratings, analysis, and trends on particular municipal bond issuances.
- Moody's. A free account can be created to provide access to credit ratings, analysis, and trends on particular municipal bond issuances.
- The municipality's public website
- Bank's investment broker/advisor

Appendix A

Credit Risk Assessment of Bank Investment Portfolios *FDIC Supervisory Insights Journal: Summer 2013*

Background
In its summer 2013 Supervisory Insights Journal, the FDIC addressed adjustments to investment grade standards and the impact of those adjustments will have on the FDIC examination process. The article provides clarification on how the FDIC will interpret the OCC rules and why the new investment-grade standards do not represent a paradigm shift from previous supervisory guidance. Additionally, the article discusses why the rule permits flexibility in how banks assess credit risk and how examiners will work with banks in their effort to comply with the rule.

Key Points from the Article

- From a bond analysis and investment due diligence perspective, the need to look beyond the credit rating is not a new supervisory expectation. Existing guidance reflect the need to have a robust credit risk management framework for securities.
- Supervisors' emphasis has shifted with the Dodd-Frank Act and the issuance of the OCC regulation. Examiners will focus less on credit ratings and more on the adequacy of pre-purchase analysis.
- The Dodd-Frank Act does not require states to change their laws on permissible investments. It is likely there will be circumstances where state law requires that an investment meet a credit rating threshold. In these cases, banks will need to meet the threshold and perform the due diligence commensurate with the OCC regulation.
- Three general points about due diligence are worth emphasizing:
    - The OCC regulation is not envisioned to significantly change the scope of permissible investments;
    - Dodd-Frank does not prohibit institutions from considering credit ratings as part of their due diligence;
    - The depth of due diligence that examiners expect will depend in part on the size, complexity, and risk characteristics of the securities portfolio.
- Banks have processes and procedures in place to effectively evaluate credit risk in their loan portfolios. Similar processes could be adopted for securities.
- The OCC's rule includes exemptions. US Treasury securities and federal agency bonds will not require credit analysis. Certain municipal bonds will also not require credit analysis to determine if the investment-grade standard has been satisfied, but institutions will have to have a sufficient understanding of credit risk in those to meet safety and soundness standards.
- The OCC purposely did not issue prescriptive guidance that detailed procedures for every instrument or situation; this gives bankers more flexibility.
- Supervisory agencies expect the transition away from reliance on credit ratings to entail a learning curve for both bankers and examiners. As long as management demonstrates that it has made good-faith progress to comply with the OCC rule, FDIC examiners, at their initial examination reviews, will work with banks as they transition away from a ratings-centric bond selection and monitoring process.
- The OCC's guidance contains a matrix of factors to consider as part of a credit risk assessment to meet the standards. Bankers should benefit from reviewing the matrix. In the FDIC's article, it provides some examples of due diligence templates bankers can use, but they are not required to. They are for informational purposes.

The FDIC's summer 2013 Supervisory Insights Journal can be viewed here. The relevant article is the first article in the journal.

Appendix B

Classification Definitions

The following definitions apply to assets adversely classified for supervisory purposes:

- A **Substandard** Asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

- An asset classified **Doubtful** has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

- Assets classified **Loss** are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.