December 6, 2011

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson, Director
Division of Risk Management Supervision

SUBJECT: *Notice of Proposed Rulemaking Regarding Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities; Proposed Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security is Eligible for Investment Under Part 362*

Proposal: That the Board of Directors ("Board") of the Federal Deposit Insurance Corporation ("FDIC") approve the attached Notice of Proposed Rulemaking ("proposed rule") titled, *Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities* and the proposed guidance document titled, *Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security is Eligible for Investment Under Part 362.* If approved, the proposed rule and guidance document would be published in the *Federal Register* for a 60-day public comment period.

Discussion: Section 28(d) of the Federal Deposit Insurance Act ("section 28(d)") currently prohibits savings associations from acquiring or retaining a corporate debt security that is not "of investment grade." Section 939(a) ("section 939(a)") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") amends section 28(d) to prohibit savings associations from acquiring or retaining a corporate debt security that does not satisfy creditworthiness standards established by the FDIC. Section 939(a) is effective for state and federal savings associations on July 21, 2012.

Part 362 of the FDIC's regulations, 12 C.F.R. part 362, implements section 28(d) and sets forth the requirements, restrictions, and limitations applicable to the investment activities of insured state bank savings associations. In accordance with the requirements of section 28(d) as amended by section 939(a), the proposed rule would revise part 362 to prohibit a savings association from acquiring or retaining a corporate debt security unless the savings association, prior to acquiring the security, and periodically thereafter, determines that the issuer of the security has adequate capacity to meet all financial commitments under the security for the projected life of the investment. An issuer would satisfy this requirement if it presents a low risk of default and is likely to make full and timely repayment of principal and interest. The proposed rule does not revise current supervisory practice with respect to nonconforming corporate debt securities investments. That is, if a security acquired in compliance with the

Concur:

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proposed rule experiences credit impairment or other deterioration following its acquisition, the appropriate federal regulator may require a state savings association to take corrective measures on a case by case basis. The proposed rule would apply to state and federal savings associations. (Currently the requirements of part 362 regarding permissible corporate debt security investments of a savings association apply only to state savings associations.)

The proposed rule is consistent with standards of creditworthiness adopted or proposed for adoption by other federal agencies in accordance with the requirements of section 939A of the Dodd-Frank Act.[1] For example, a proposed rule released by the Securities and Exchange Commission's (SEC) would amend SEC Rule 5b-3 to require that certain funds limit investments to issuers that, based on the fund's determination, have the highest capacity to meet their financial obligations.[2] Similar to the proposed rule, the SEC rule would require a regulated entity to make a creditworthiness determination based on various creditworthiness factors (described below and in the proposed guidance document) and periodically review such determination. In accordance with the requirements of section 939A of the Dodd-Frank Act, under the proposed rule, a savings association would be permitted to use an external credit assessment (including an credit rating from a nationally recognized statistical rating organization ("NRSRO")) as one of several factors in determining the creditworthiness of the issuer.

The proposed rule also is consistent with the existing investment risk management practices of banks and savings associations, which currently are expected to maintain a risk management process to ensure that credit risk is effectively identified, measured, monitored, and controlled.[3] Effective risk management requires consideration of and due diligence based on factors other than an external credit assessment. Accordingly, the proposed rule should not impose a significant burden on federal or state savings associations or affect the scope of securities currently eligible for investment by a savings association under part 362.

The proposed rule is accompanied by a proposed guidance document that would set forth the FDIC's expectations for savings associations conducting due diligence to determine whether a corporate debt security is eligible for investment under the proposed rule. The proposed guidance describes several factors that savings associations should consider in making this determination. For example, the proposed guidance recommends considering internal analyses, third-party research and analytics including external credit ratings, internal risk ratings, default statistics, and other sources of information appropriate for the particular security. However, 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.

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[1] The purposes of section 939A of the Dodd-Frank Act are similar to the purpose of section 939(a).

[2] See 76 FR 12896 (proposed March 9, 2011). In that NPR, the SEC imposed a higher standard of creditworthiness because prior to the Dodd-Frank Act, Rule 5b-3 required investment to have the *highest* rating from an NRSRO. Prior to the Dodd-Frank Act, part 362 of the FDIC's regulations defined investment grade as one of the four highest ratings from a NRSRO.

[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.

FDIC staff expects the OCC to soon release a notice of proposed rulemaking to amend part 1, Investment Securities, in a manner consistent with the requirements of the proposed rule. The OCC proposal would permit a national bank to consider a credit rating as one of several factors in determining whether a security is eligible for investment under part 1 of the OCC's regulations.

Recommendation: That the Board approves publication of this proposed rule and proposed guidance in the *Federal Register* for a 60-day public comment period.

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