CORPORATE CREDIT UNION GUIDANCE LETTER

NO. 2013-01 DATE: April 16, 2013

SUBJ: Final Rule - Alternatives to the Use of Credit Ratings

TO: The Corporate Credit Union Addressed

The purpose of this letter is to provide supervisory guidance on creditworthiness and credit risk management for corporate credit unions following the issuance of NCUA Final Rule *Alternatives to the Use of Credit Ratings* published in the Federal Register on December 13, 2012.[1] The rule implemented statutory requirements in Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act, by removing references to credit ratings in the NCUA regulations and replacing them with other appropriate standards. The rule is effective June 11, 2013.

Actions of Other Regulators

The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) issued final rules and supervisory guidance in the Federal Register in June/July 2012.[2] In November 2012 the Board of Governors of the Federal Reserve issued SR 12-15 on *Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organizations* (NRSRO).[3] The guidance of this letter applies to all state member banks. The Federal Reserve's letter informs banks that, effective January 1, 2013 they may no longer rely solely on credit ratings to determine whether a security is permissible for investment by a state member bank.

Final Rule Standards

The NCUA Final Rule issued in December uses two standards to replace the various NRSRO creditworthiness references existing in the regulations. The standards are "minimal amount of credit risk" and "investment grade."

The final rule defined "minimal amount of credit risk" as follows:

> *Minimal amount of credit risk* means the amount of credit risk when the issuer of a security has a very strong capacity to meet all financial commitments under the security

[1] 77 FR 74103 (Dec. 13, 2012).
[2] OCC Final Rule and Guidance 77 FR 35253, 25259 (June 13, 2012); FDIC Final Rule and Guidance 77 FR 43151, 43155 (July 24, 2012).
[3] Federal Reserve Board of Governors, SR 12-15, November 15, 2012.

> for the projected life of the asset or exposure, even under adverse economic conditions. An issuer has a very strong capacity to meet all financial commitments if the risk of default by the obligor is very low, and the full and timely repayment of principal and interest on the security is expected. A corporate credit union may consider any or all of the following factors, to the extent appropriate, with respect to the credit risk of a security: Credit spreads; securities-related research; internal or external credit risk assessments; default statistics; inclusion on an index; priorities and enhancements; price, yield, and/or volume; asset class specific factors. This list of factors is not meant to be exhaustive or mutually exclusive.

Except in one instance noted below, the creditworthiness standard that applies to corporate credit unions is the "minimal amount of credit risk" standard as stated in Section 704.6(f) of the final rule. The final rule also provided the following definition of "investment grade."

> *Investment grade* means the issuer of a security has an adequate capacity to meet the financial commitments under the security for the projected life of the asset or exposure, even under adverse economic conditions. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest on the security is expected.

The preamble to the rule indicates the "minimal amount of credit risk" standard is higher than the "investment grade" standard and says that this is appropriate for corporate credit unions due to their mission to provide liquidity to credit unions in a range of economic circumstances. The preamble to the rule noted that revision of corporate credit union regulations occurred in 2010 in order to facilitate the role of corporate credit unions. The preamble justifies the higher standard by noting that "as liquidity facilities, corporates must maintain high quality, marketable investments that can be sold quickly, without incurring undue loss, to fund loan and share demands."

Corporate credit unions authorized under Appendix B Part II to engage in certain foreign activities, and Part III to engage in derivative activities must establish there is "minimal amount of credit risk" in the issue or issuer, or counterparty, in these transactions. The rule also removes credit rating references in all risk-weightings for purposes of calculating risk-based capital.

The final rule applies the standard of "investment grade" to corporate credit unions which are granted Expanded Authority under Section 704, Appendix B Part I authority.

Application of the NCUA Rule

The primary focus of this guidance is to affirm NCUA's expectation that corporate credit unions will maintain the credit quality of their securities, their issuers, and any counterparties, in all investment transactions following NCUA's final rule. The preamble to the rule states that "the NCUA Board does not intend for the elimination of references to credit ratings to fundamentally change the standards that corporates should use when deciding whether a security is eligible for purchase." Likewise the preamble to the rule states "the NCUA Board is revising § 704.6(h)(1) to trigger the requirement to prepare an investment action plan if appropriate monitoring of the investment would lead to the reasonable conclusion that the investment's credit quality has more than a minimal amount of credit risk."

The Office of National Examinations and Supervision (ONES) will ensure that corporate credit unions utilize the final rule to take a variety of factors into account in assessing creditworthiness. The reason for broadening the method of assessing credit risk at this time is that distributions of default and non-repayment widened during 2007 and afterward, increasing the tails in defaults and loss severities, which compromised the statistical reliability of historical performance attributes. Accordingly, ONES urges corporate credit unions to adopt a range of methods to assess investment credit quality in order to minimize tail risk, and avoid over-reliance on any single source, including that of credit ratings.

Guidance issued by the OCC and the FDIC addresses securities which are "investment grade." Corporate credit unions should take this difference into consideration if they refer to this guidance for their own purposes. Some aspects of guidance issued by other regulators are nevertheless relevant for corporate credit unions. For example, ONES recommends that institutions should understand the impact of economic stresses on investment cash flows, including changes in economic growth, stock market movements, unemployment rates, and the impact of home values on defaults and loss severities. ONES believes that management may not delegate its responsibility for decision-making in any use of third parties in analytical credit risk assessment and should ensure that prospective third parties are independent, reliable and qualified. ONES will also enforce the principle that 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. The more complex a security's structure, the more credit-related due diligence an institution should perform, even when the credit quality is seen to be high.

Accurate assessment of credit risk continues to be a critical responsibility of corporate credit unions. Credit standards should continue to be clearly articulated in policy, and the maintenance of standards implemented by senior management. Corporate credit unions should not ignore the conclusions of the rating agencies entirely, any more than relying on them exclusively. Where conflicting assessments of credit quality are created by the use of multiple evaluative factors, the corporate credit union will have a greater burden to support its determination. As stated in the Final Rule, ONES does not intend for the elimination of references to credit ratings, in accordance with the Dodd-Frank Act, to substantively alter the standards in maintaining investment securities with a minimal amount of credit risk. When corporate credit unions apply a range of methods and metrics to accurately evaluate credit risk, the level of credit risk in investment securities at corporate credit unions should be unchanged.

Alternative Credit Assessment Factors

The preamble to the NCUA rule identifies certain elements that will assist credit unions in evaluating the credit quality of a security, and states the use of each of these alternatives. These factors were also identified by the Securities & Exchange Commission (SEC) in a proposed rule *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934.*

This proposed rule was published in the Federal Register, May 6, 2012.[4] The preamble to the NCUA rule provides instances for each alternative. The alternatives described in the NCUA rule are consistent with the SEC's proposed rule and they are as follows.

- **Credit spreads** (*i.e.,* whether it is possible to demonstrate that a security is subject to a particular amount of credit risk based on the spread between the security's yield and the yield of Treasury or other securities);
- **Securities-related research** (*i.e.,* whether providers of securities-related research believe the issuer of the security will be able to meet its financial commitments, generally or specifically, with respect to the securities held by the credit union);
- **Internal or external credit risk assessments** (*i.e.,* whether credit assessments developed internally by the credit union or externally by a credit rating agency, irrespective of its status as an NRSRO, express a view as to a particular security's credit risk);
- **Default statistics** (*i.e.,* whether providers of credit information relating to securities express a view that specific securities have a probability of default consistent with other securities with a particular amount of credit risk);
- **Inclusion on an index** (*i.e.,* whether a security, or issuer of the security, is included as a component of a recognized index of instruments that are subject to a specific amount of credit risk);
- **Priorities and enhancements** (*i.e.,* the extent to which a security is covered by credit enhancements, such as overcollateralization and reserve accounts);
- **Price, yield, and/or volume** (*i.e.,* whether the price and yield of a security are consistent with other securities that the credit union has determined are subject to a particular amount of credit risk and whether the price resulted from active trading); and
- **Asset class-specific factors** (*e.g.,* in the case of structured finance products, the quality of the underlying assets).

A corporate credit union must exercise sound credit judgment in applying each of these evaluative factors. For example, the use of credit spreads and indices requires that a corporate credit union assess whether the market determined spread is a good proxy for credit quality. The credit union should determine whether any specific index is appropriate and whether, for example, the London Interbank Offering Rate (LIBOR), or a Treasury index, should serve as the basis. A corporate credit union should evaluate any credit spreads by taking into account the time of pricing and whether the security is rich or cheap relative to other securities, while considering the price, yield and traded volume of securities. A corporate credit union should be aware that the liquidity and the marketability of a security will affect the spreads of the security to any index identified, and consider this when evaluating a security.

Research and internal and external assessments of the credit quality of a security will vary according to the security type. In some cases, such as a corporate bond, the creditworthiness of the counterparty and the risk of default is the central concern and the main focus is on the counterparty's financial strength and performance. In other cases, such as municipal securities, the budgetary strength of the municipality, its level of unfunded liabilities, the extent of taxing

[4] SEC Proposed Rule 76 FR 26550 (May 6, 2011).

authority, and the strength of underlying revenue sources, are central. In the case of the structured securities which comprise a large segment of corporate credit union portfolios, the elements include the following:

- Class/tranche and position in the cash flow waterfall of a securitized structure;
- Loss allocation rules, definitions of default, impact on performance, and market value triggers;
- Support provided by credit enhancements and/or liquidity enhancements, such as excess spread, overcollateralization and reserve accounts;
- Risk concentrations in underlying collateral, such as local demographics and economics that may contribute to default or diminished repayment;
- Contributing factors in special servicing, legal and credit administration;
- Quality of underwriting of underlying collateral and consistency with historical performance;
- The impact of collateral deterioration on tranche performance, default rates and loss severities under adverse circumstances;
- Performance of individual commercial properties in the case of commercial mortgage related securities; and
- Present and future contribution of guarantees when issued by government agencies.

ONES expects that the impact of removing credit ratings from NCUA regulations will prompt corporate credit unions to consider the analytical elements of credit risk in investment securities in more detail, in greater depth, and with increased care. Far from providing license to credit unions to interpret credit quality more liberally in the absence of ratings, ONES instead requests corporate credit unions to rigorously examine the credit quality of their securities both at time of purchase and in formulating any investment action plans. Securities with more than a minimal amount of credit risk, based on the factors described above, will be considered to have failed to meet the requirement of the regulation, as referenced in Section 704.10 "Investment Action Plan." This applies to all corporates, unless they have Part I Expanded Authority, in which case the investment grade standard applies.

Credit Risk Management

Section 704.6 "Credit Risk Management" of the NCUA Regulations is unchanged except for the removal of credit rating agency references, and the substitution of a requirement that a corporate determine an investment has no more than a minimal amount of credit risk, except for those with Part I Expanded Authority as previously stated. ONES will continue to apply the existing regulations with respect to corporate credit union policies, sector concentrations including corporate debt subsector limits, and reporting and documentation. ONES also encourages corporate credit unions to take this opportunity to reassess their own practices for credit analysis and credit quality.

In the event the corporate credit union becomes aware of credible information about a security or its issuer that suggests possible deterioration in the credit quality, it should promptly reassess whether this continues to present minimal credit risks. By this means corporate credit unions can continue to exercise diligence in light of any new information affecting the credit quality of the securities they hold.

If you have any questions, please contact this office via email at ONESMail@ncua.gov or by phone at 703.518.6640.

Sincerely,

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