

SUPERVISORY LETTER

NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF EXAMINATION AND INSURANCE
1775 DUKE STREET, ALEXANDRIA, VA 22314

DATE: June 11, 2013 Supervisory Letter No. 13-03

TO: All Field Staff

SUBJECT: Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organizations (NRSRO) Ratings

This Supervisory Letter provides examiners with guidance on the final rule implementing certain statutory requirements in Title IX of the Dodd Frank Act pertaining to the use of credit ratings by natural person credit unions. The guidance discusses how a credit union needs to fulfill its responsibility to make an independent determination about the risks associated with its investment purchases without the sole reliance on NRSRO credit ratings. In particular, the guidance:

- Addresses why ratings have been removed from regulations per Title IX of the Dodd Frank Act;
- Provides regulatory expectations for credit unions in considering factors involved in a creditworthiness determination without sole reliance on credit ratings;
- Outlines key factors to consider in analysis for specific security types, counterparty agreements and credit risk;
- Gives additional guidance for structured securities analysis; and
- Clarifies situations whereby investment positions are grandfathered.

If you have any questions on this Supervisory Letter, please direct them to your immediate supervisor or regional management.

Sincerely,

/s/

Larry Fazio, Director,
Office of Examination & Insurance



Supervisory Letter



Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organizations (NRSRO) Ratings

I. Introduction

The recent financial crisis highlighted the markets' over-reliance on credit ratings. Financial institutions and other investors suffered significant losses from once highly-rated securities – especially certain structured finance products which experienced unprecedented defaults or severe downgrades of their external credit ratings. Many investors, including natural person and corporate credit unions, placed undue reliance on NRSRO credit ratings by failing to perform an independent analysis of the credit-worthiness of an investment.

II. Credit Unions Subject to this Guidance

This Supervisory Letter provides examiners with guidance regarding the interpretation of the final rule implementing certain statutory requirements in Title IX of the Dodd Frank Act pertaining to the use of credit ratings by natural person credit unions.¹ For federally chartered credit unions (FCUs), the rule applies as to the permissibility of an investment. For federally insured state chartered credit unions (FISCUs), the rule is applicable to the establishment of a reserve account for investments not conforming to Part 703 and in evaluating safety and soundness of investments purchased by the credit union.² The following guidance will illustrate how a credit union should fulfill its responsibility to make an independent determination about the risks associated with its investment purchases without the sole reliance on NRSRO credit ratings.

III. Background

¹ For Corporate Credit unions, see Guidance Paper 2013-01

² 12 CFR §741.3(a)(2) *Special reserve for nonconforming investments*. State-chartered credit unions are required to establish an additional special reserve for investments if those credit unions are permitted by their respective state laws to make investments beyond those authorized in the Act or the NCUA Rules and Regulations

Section 939A of the Dodd-Frank Act requires all federal agencies, including NCUA, to review their regulations for any use of NRSRO credit ratings and substitute with standards of creditworthiness that are deemed appropriate. In December 2012, the NCUA Board issued a Final Rule to implement section 939A. This rule is effective June 11, 2013.

For natural person credit unions, the NCUA Board is replacing the various NRSRO-based security creditworthiness standards in NCUA regulations with the standard “investment grade.”

IV. The Replacements of Ratings

The NCUA’s elimination of references to credit ratings in its regulations, in accordance with the Dodd-Frank Act, does not substantively change the standards FCUs should use when deciding whether securities are eligible for purchase. The NCUA Board is replacing the various NRSRO based security creditworthiness standards in NCUA regulations with a standard of “investment grade”. NCUA's regulations still require a FCU to determine whether or not a security type is permissible.

An “**investment grade**” security is one where the credit union determines that the issuer has an adequate capacity to meet all 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.

For regulations pertaining to investment securities,³ the rule replaced the minimum credit ratings requirement with a requirement that the FCU conduct and document a credit analysis demonstrating that the issuer of the security has an adequate capacity to meet all financial commitments. Despite the removal of NRSRO ratings thresholds, the rule states that a credit union may use internal and external assessments when evaluating the financial strength of an issuer.

For regulations pertaining to counterparty transactions, the rule replaces minimum rating requirements with a requirement that the credit union conduct a credit analysis of the counterparty based on standards approved by its board of directors.⁴

§ 703.9 (d) is amended in the final rule to replace reference to “reports of NRSRO’s” with the term “external assessments of creditworthiness.”⁵

³ §703.14 Permissible investments.

⁴ § 703.14: At the time the Federal credit union purchases the securities, the counterparty, or a party fully guaranteeing the counterparty, must meet the minimum credit quality standards as approved by the Federal credit union's board of directors.

V. Determination of Credit Quality and Due Diligence

The NCUA expects FCUs to consider a number of factors when making a creditworthiness determination. FCUs may continue to use credit ratings and NRSRO research to augment their due diligence. Ratings may supplement but cannot be the sole basis to determine suitability. 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 for investments considered to be of high credit quality. Management must understand the security's structure and how the security may perform in different economic and default environments. Management needs to be particularly diligent when purchasing structured securities. For example, an FCU should be able to demonstrate an understanding of the effects on cash flows for a structured security assuming varying default levels of the underlying assets. [For a list of securities types, credit due diligence level expectation and risks to consider, see Table 1 and Table 2 on page 4.]

Table 1.

Instruments	Key Factors to Consider in Analysis
Private Issue Residential Mortgage Backed Security	Class tranche, relative position in cash flow waterfall, underwriting and collateral quality, adequacy of subordination levels, impact of

⁵ § 703.9: Annually, the Federal credit union must analyze the ability of the safe keeper to fulfill its custodial responsibilities, as evidenced by capital strength, liquidity, and operating results. The Federal credit union should consider current financial data, annual reports, external assessments of creditworthiness, relevant disclosure documents, and other sources of financial information.

	collateral deterioration on tranche performance.
Private Issue Commercial Mortgage Backed Security	Class tranche, relative position in cash flow waterfall, underwriting and collateral quality, adequacy of subordination levels, impact of collateral deterioration on tranche performance.
Municipal Securities (Rated)	Confirm spread to U.S. Treasuries consistent with bonds of similar quality, capacity to pay, debt profile, soundness of budget process, stability of revenue sources and taxing authority.
Municipal Securities (Unrated)	Source and strength of revenue structure, reserve levels, debt service and coverage ratios, legal covenants and nature of project
Bank Notes (Uninsured)	Confirm spread to U.S. Treasuries consistent with bonds of similar quality, capacity to pay, financial performance levels and trends, third party analytics as appropriate.
Mutual Funds	Investment permissible as long as the fund restricts investments and transactions that are permissible for federal credit unions.

Table 2.

Counterparty Agreements	Key Factors to Consider in Analysis
Repurchase Agreements	Counterparty meets minimum credit quality standards as approved by FCUs Board of directors.
Securities Lending	Counterparty meets minimum credit quality standards as approved by FCUs Board of directors.
European Financial Options Contracts	Legal, Counterparty; Aggregate amount of equity linked member share certificates cannot exceed 50% of FCU's net worth.
Mortgage Note Repurchase Transactions	Legal, Counterparty, Aggregate of investments with a single counterparty limited to 25% of net worth; 50% of net worth for all counterparties.

The extent of the due diligence should be sufficient to support the credit union's conclusion that the credit quality is consistent with its own internal investment policy credit standards. Third-party analytics may be part of this analysis, although the FCU's management remains responsible for the investment decision and should ensure that prospective third parties are independent, reliable, and qualified. Credit unions are responsible for making a final determination on suitability and credit worthiness and cannot shift this obligation to third party vendors.

VI. Elements of Credit Analysis

An FCU may consider any or all of the following factors, to the extent appropriate, with respect to a security's credit risk:

Credit spreads – 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 comparable maturity Treasury or other securities.

Securities-related research – 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 – whether credit assessments developed internally by the FCU 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 – 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 – 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 – the extent to which a security is covered by credit enhancements, such as overcollateralization and reserve accounts.

Price, yield, and/or volume – 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.

VII. Additional Guidance on Structured Securities Analysis

In the case of structured securities,⁶ credit risk determination may be influenced by the quality of the underlying collateral, the securities’ cash flow rules, and the structure of the security itself more than the condition of the issuer. It is critical that management understand the creditworthiness assessment for an investment security relying on the cash flows and collateral of the underlying assets for repayment. Structured securities are inherently different from a security that relies on the financial capacity of the issuer for repayment. For example, a REMIC or Collateralized Mortgage Obligation requires a different evaluation framework than a bank note or debenture. Structured securities are issued in a variety of forms. It is important for the credit union’s investment manager to match the level of due diligence with the level of complexity of the structured security.

Therefore, the credit union should demonstrate an understanding of the features of a structured security that would materially affect its performance and provide evidence that its risk of loss is low under adverse economic conditions. Management must understand the security’s structure and performance using scenario analysis that evaluates how a security will perform in different economic environments. Policies that specifically permit this type of investment should establish

⁶ The term, “structured security” includes, but is not limited to, any type of fixed income obligation or type of collateralized self-liquidating financial asset, such as mortgages or receivables, which entitles the security holders to receive payments that depend upon the cash flow from the underlying assets, including a mortgage backed security, a collateralized mortgage, debt or bond obligation, any multi-class securitization structures special purpose entity issuers, a structured agency note or an index amortizing note.

appropriate limits and pre-purchase due diligence processes. Credit unions must understand the effect economic stresses may have on an investment's cash flows. Market research and internal and external assessments of the credit quality of a security will vary according to the security type. In some cases, the creditworthiness of the counterparty and its risk of default is a primary concern. The main focus is on the counterparty's financial strength and performance. In other types, such as municipal securities, the budgetary strength of the municipality, its level of unfunded liabilities, the extent of taxing authority, and the strength of underlying revenue sources is the primary credit focus.

In the case of structured securities, elements to consider in assessing credit worthiness include the following:

- Class/tranche and position in the cash flow waterfall of a securitized structure;
- Loss allocation rules, definitions of default, impact 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 and consistency of underwriting of underlying collateral;
- 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.

VIII. Safekeeping Agents and Broker-Dealers

NCUA Rules and Regulations list a number of factors that credit unions should consider when evaluating the reliability of broker-dealers and investment safe keepers, respectively. One factor is NRSRO ratings. The rule replaces the NRSRO reference in those sections with the phrase “external assessments of creditworthiness.”

IX. Credit Union Investments Managed by Discretionary Money Managers

Although FCUs may contract with vendors to determine credit worthiness, it remains the FCU's responsibility to make the final determination of whether the investment is permissible under §703.14. The FCU must instruct the money manager to only invest in securities permitted under

§703.14. The FCU should understand the investment analysis framework and methodology performed by the investment manager. Frequent monitoring is required to verify investments remain in compliance with all rules and regulations.

X. Mutual Funds

The FCU may only invest in mutual funds that invest in securities that are permissible under §703.14. This requirement applies to all holdings of the fund without exception. It is the responsibility of the FCU to periodically monitor the investment holdings of the fund to verify compliance as to permissibility of investment type.

XI. Grandfathered Investments

Provisions of §703 grandfathered municipal securities and transactions before and within certain dates. Credit unions that exceed the municipal security limit on the effective date of this rule will not be required to divest a portion of their position. The credit union must have a board approved plan to bring the position into compliance. If an FCU added instruments to its portfolio during the period between the public register notice of the approved final rule (December 12, 2012) and the effective date of the final rule (June 11, 2013) and in an amount that caused it to exceed the current limitations, divestiture may be required. In deliberating a divestiture directive, examiners should evaluate the process by which the purchases were made, the degree by which the position exceeds the current limit, and the effectiveness of the credit union's portfolio risk management process.

As a matter of sound practice, credit unions must manage the credit risk inherent in their investment securities and transactions by taking into account the risk of deterioration. Credit unions have an ongoing obligation to reevaluate creditworthiness and address deterioration as appropriate. As is the case in making a loan to their members, a credit union's initial evaluation of credit quality at the time of purchase is not a permanent justification for asset retention.

XII. Conclusion

Title IX of the Dodd Frank Act mandated the removal of references to NRSRO ratings from federal regulations in response to an over reliance upon such ratings by investors. The use of NRSRO investment ratings is still allowed to be used in credit union investment policy statements and also as part of the due diligence analysis performed by the credit union. The removal of credit ratings from regulations compels NCUA to reiterate the importance of having a sound due diligence process within the credit union to manage investment credit risk. Examiners should refer to this guidance to evaluate a credit union's determination about the risks associated with its investment purchases and the factors to consider in assessing these risks.