



OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Unsafe and Unsound Investment
Portfolio Practices

Description: Supplemental Guidance

TO: Chief Executive Officers of All National Banks, Federal Branches and Agencies, and All Examining Personnel

PURPOSE

This bulletin alerts banks to the potential risk to future earnings and capital from poor investment decisions made at the current low level of interest rates. It emphasizes the importance of maintaining prudent credit, interest rate, and liquidity risk management practices to control risk in the investment portfolio. This guidance supplements OCC Bulletin 98-20, "Investment Securities: Policy Statement," dated April 27, 1998.

CONTENTS

PAGE

Background	1
Unsound Investment Practices	2
1. Yield Chasing - Credit Risk	2
2. Yield Chasing - Interest Rate Risk	4
3. Yield Chasing - Combinations of Credit, Interest Rate and Liquidity Risk	5
Risk Management Considerations	7
Supervisory Review of Investment Activities	8

BACKGROUND

The Federal Reserve has reduced overnight lending rates 11 times since January 2001. These rate reductions, coupled with soft loan demand, asset prepayments, and core deposit inflows, have put pressure on asset yields and net interest margins for many banks. Unwilling to accept low overnight yields, many banks have looked to their investment portfolios to generate higher yields. While this is an understandable response to the current economic climate, it is fraught with longer-term risks if not controlled properly. The OCC has observed a number of recent cases where banks have engaged in unsafe and unsound practices, particularly regarding the assumption of credit risk, in an effort to increase investment portfolio yields. The OCC wants to alert banks to these unsound practices and underscore the importance of an appropriate risk management system.

UNSOOUND INVESTMENT PRACTICES

Some banks have seen such a large decline in their investment yields that, faced with the alternative of selling a large amount of funds at very low overnight rates, they are “chasing” investment yields. These banks have allowed the fear of rapidly declining asset yields to override prudent banking judgment and, in some cases, to assume unwarranted levels of risk. In many cases, banks have not taken steps to strengthen their risk management practices and policy controls consistent with the increase in their tolerance for risk.

There is no “free lunch.” To obtain higher yields, banks must take more credit risk, interest rate risk, liquidity risk, or combinations thereof.

National banks must ensure that they have an appropriate risk management framework in place for the level of risk taken in their investment portfolios. Banks choosing to increase their risk tolerance must reassess their risk management processes to ensure they are appropriate for current and projected risk profiles.

1. Yield Chasing – Credit Risk

There are a variety of ways banks have chased yields, but potentially the most dangerous involves purchasing investment assets at the lower end of the permissible credit quality spectrum. Legal requirements generally mandate that banks purchase securities that are rated investment grade or, if not rated, are the credit equivalent of investment grade. Many banks have purchased corporate, municipal and asset-backed securities that are at the lower end of investment grade, trying to take advantage of the higher yields available on such assets.

Yield is an important consideration when a bank evaluates a security for purchase, and it is not inherently an unsafe and unsound practice to purchase high-yielding securities that are at the low end of the investment grade rating scale. However, when banks change their investing practices to take on more credit risk without appropriate credit due diligence, limits, and guidelines (including higher capital when needed), such practices become unsafe and unsound.

The further down the credit quality spectrum a bank invests, the more critical it becomes to supplement ratings from credit rating agencies with internal credit analysis. External credit ratings often are lagging indicators of credit quality. If a bank relies exclusively upon a credit rating, and does no internal analysis, it may find it has not received sufficient yield to compensate for the additional risk recognized in the market but not yet reflected in credit ratings. When a bank purchases securities rated at the bottom end of investment grade (e.g., Baa3/BBB-), a subsequent downgrade will result in a classified asset.¹ Default will generally result in an assessment that depreciation is “other than temporary” and the bank will have to recognize the security’s depreciation as a current period expense. The record volume of corporate defaults in 2001 underscores the risks involved in chasing yield down the credit spectrum.²

¹ See OCC Banking Circular 127, “Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks” for a discussion of classification standards.

² Standard & Poor’s Corporation reported on January 14, 2002 that 211 issuers, or 3.99% of all issuers, defaulted on \$115.4 billion of debt in 2001. The previous record, 132 issuers defaulting on \$42.3 billion of debt, occurred in 2000. Moreover, defaults by issuers rated investment grade at the beginning of the year nearly matched the record set in 1982. On January 31, 2002, Standard & Poor’s reported that defaults for January, 2002 set multiple records. Forty-one issuers worldwide defaulted on \$31.3 billion in rated bonds.

Non-Rated Securities. The OCC has observed that some banks have not done the credit due diligence necessary to show that non-rated securities are the credit equivalent of investment grade, as required by 12 CFR 1.2(e). It is not unsafe or unsound to purchase non-rated securities. However, to show that a non-rated security is the credit equivalent of investment grade, a bank must document, through its own credit assessment and analysis, that the security is a strong “pass” asset under its internal credit rating standards.³ This rule also applies to securities that have principal, but not interest, rated. Banks must show that the interest portion is the credit equivalent of investment grade. Originating credit exposures without adequate credit due diligence is an unsafe and unsound banking practice. Moreover, as a prudent credit practice, banks should review the quality of material holdings of non-rated securities on an ongoing basis after purchase. Banks that fail to perform and document the necessary credit analysis are not in compliance with 12 CFR 1 and the sound investment practices outlined in OCC 98-20.

National banks must have a documented analysis that supports the determination of credit equivalence of investment grade for each purchased non-rated security.

Securities Rated Below Investment Grade. The OCC has also observed problems when banks have used their legal lending authority to acquire securities rated below investment grade but have failed to perform the credit analysis necessary to satisfy safety and soundness standards.⁴ It is not unsafe or unsound for banks to acquire investment assets using the bank’s legal lending authority; the OCC has issued several precedent letters permitting such transactions. Banks typically use their lending authority to acquire securities when the securities do not conform to either the quality (i.e., investment grade rating) or marketability requirements of 12 CFR 1. However, banks that use their lending authority to acquire securities must apply the same standards of credit analysis, underwriting, and approval as they would normally apply to large corporate loans. In addition, banks must make the decision to use their legal lending authority to acquire securities before purchase, not after. It is unacceptable to buy securities that do not meet the quality or marketability requirements of 12 CFR 1 and then call them “loans” in an attempt to avoid a violation of the investment regulation. Examiners will review all securities a bank acquires with its lending authority to assess the bank’s credit due diligence procedures. Examiners will review the assets for classification purposes as loans and will require appropriate corrective action when banks fail to acquire these credit exposures in a prudent manner.

Securities that a bank acquires pursuant to its lending authority are subject to the accounting requirements of Statement of Financial Accounting Standards No. 115 (Accounting for Certain Investments in Debt and Equity Securities). Therefore, banks must designate them as held-to-maturity, available-for-sale, or trading. Examiners will generally consider depreciation on defaulted securities to be “other than temporary” and require banks to take losses against current period earnings.

³ Because most internal bank rating systems “pass” some credit exposures that are not, or would not be, rated investment grade, a security will generally have to be rated higher than the bottom tier of internal credit rating “pass” standards in order to be the credit equivalent of investment grade.

⁴ National banks may also acquire a limited amount of securities rated below investment grade with their investment authority. The “reliable estimates” provision in 12 CFR 1.3(i) permits banks to purchase securities that do not qualify as “investment securities” up to an aggregate amount of 5% of capital and surplus. The bank must show, through a credit analysis, that the obligor will be able to satisfy its obligations. The security must also be liquid (i.e., it can be sold with reasonable promptness at a price that corresponds reasonably to its fair value).

The use of the lending authority to acquire securities does not eliminate the need to measure, manage and control the investment risks of the securities. It is an unsafe and unsound practice to overlook the risks of investment assets simply because a bank has acquired them under its lending authority.

National banks must understand and prudently limit the price sensitivity and credit exposures of securities acquired via their legal lending authority. As part of their ongoing limits and controls, banks should also periodically obtain current prices for these securities and consistently follow the required accounting standards, including recognizing losses where appropriate.

Complex Security Structures. An additional credit issue involves the proliferation of new and complex asset-backed security structures. Two securities with identical credit ratings (e.g., Baa3/BBB-) can trade at significantly different yields depending upon the collateral backing the security and the structure of the securities. Some banks seeking to generate high yields have begun to purchase securities backed by subprime consumer paper, trust preferred stocks and corporate bonds. As the default rate for some of these asset classes has increased, the securities have depreciated rapidly and many now have “other than temporary” impairment. It is not an unsafe or unsound practice to purchase securities that have high yields simply because of the type of collateral or structural complexity. However, it is unsafe and unsound to do so without an understanding of the security structure and a scenario analysis that shows that the bank has evaluated how the security will perform in different default environments.

National banks should demonstrate an understanding of the specific type of asset-backed security structures they plan to purchase. Investment policies should specifically permit the holdings and establish appropriate limits. National banks should conduct appropriate due diligence before purchasing complex asset-backed security structures and should consider the impact of such purchases on the bank’s capital and earnings under a variety of possible scenarios.

2. Yield Chasing – Interest Rate Risk

The significant reduction in short-term interest rates brought about by Federal Reserve easing has resulted in a very steep and upward sloping yield curve. For investors trying to enhance yield, a steeply sloping yield curve provides an incentive to extend maturities. The current yield curve environment is similar to the one that prevailed during 1993, when banks faced a similar dilemma concerning how to replace the yields on called/prepaid assets. At that time, some banks made the mistake of investing a disproportionate amount of funds within a short time period and locked in a large volume of earning assets at a cyclical low point in yields. Then, as now, many banks chased yields to avoid investing excess liquidity at very low overnight rates.⁵

In 1993, many banks acquired large volumes of structured notes, focusing on the excellent credit quality of agency issuers and high yields, but overlooking the complex structures, embedded options and resultant price sensitivity. In response to concerns about risk management weaknesses for these assets, the OCC issued guidance in 1994 alerting banks to the risks of structured notes. When interest rates increased sharply in 1994, many of these investment portfolios suffered severe depreciation. For some institutions, the deterioration in security values

⁵ The federal funds rate was 3 percent in 1993; it is 1.75 percent now.

caused supervisory concerns about their viability. More recently, the OCC has observed that some banks have purchased callable securities with very long stated maturities and short non-call periods. Securities with long maturities and short non-call periods contain a combination of non-credit risk factors that often produce very high yields, and very high risk. Such structures often leave a bank vulnerable to interest rate movements in either direction: a long maturity, depreciated asset if rates increase or a prepaid asset requiring reinvestment if rates decline. Additionally, the OCC has observed that range notes, an old structured note product, have begun to reappear in bank portfolios. A range note is a long maturity, callable security that pays a very high coupon to investors as long as a market index, such as Libor, is below a specified level or within a certain range. If Libor exceeds that level, or is outside the range, the note pays no interest. Now, as earlier, many banks appear to have purchased these more complex securities without performing the necessary scenario analysis, i.e., analyzing how the security performs in different interest rate environments, or understanding the impact of the assets on the bank's overall interest rate risk profile.

It is not an unsafe or unsound practice to purchase securities with long maturities or complex options. However, it is an unsafe and unsound practice to do so in material amounts, without a pre-purchase analysis, and when the desire for yield causes management to overlook normal prudential controls. Sound investment practices dictate that management must understand the structure and price sensitivity of its security purchases, as well as how they affect the bank's overall interest rate risk profile.

The build-up of earning assets with options that allow early repayment (i.e., embedded short options) over the past decade has caused much of the current excess liquidity and declining investment yields as borrowers and security issuers have prepaid or called their debt obligations. The greater the percentage of earning assets that the bank's debtors (borrowers or security issuers) can redeem at their option, the greater the likelihood that a large decline in interest rates will cause a significant erosion in earning asset yields. Banks should resist the temptation to invest material amounts of funds in securities with long stated maturities within a short period of time. A portfolio that has diversification, both in maturities and in the timing of security purchases, should reduce a bank's vulnerability to an investment portfolio that performs poorly if interest rates rise. It will help to avoid the possibility that the investment portfolio will serve as a drag on earnings for years to come.

National banks should review the volume of their earning assets with embedded short options and establish appropriate limits to control the severity of future problems associated with rapidly changing interest rates.

3. Yield Chasing – Combinations of Credit, Interest Rate, and Liquidity Risks

Banks have recently raised questions about purchasing investment securities or other financial instruments that present some combination of higher credit risk, interest rate risk or liquidity risk due to their maturity, options or structure. Trust preferred securities, equity-linked CDs and bank-owned life insurance (BOLI) are three types of assets that warrant further attention in the current environment.

Trust Preferred Securities. A number of banks have acquired significant amounts of trust preferred securities and failed to recognize the associated interest rate, liquidity, and credit risks arising from the terms of these securities. In fact, some banks mistakenly believe that the credit

exposure arising from purchasing trust preferred securities issued by a bank holding company is similar to the credit exposure arising from selling federal funds to a bank that is a member of that holding company. It is not.

Unlike federal funds sold to a bank that is a member of a holding company, a trust preferred security generally is not an obligation of a bank. Trust preferred securities are typically issued by a subsidiary grantor trust of a bank holding company, which uses the proceeds of the equity issuance to purchase deeply subordinated debt issued by the bank holding company. The securities contain an option that allows the issuer to defer payment of dividends for up to five years, without representing an event of default. While the tenor of federal funds transactions is usually overnight, trust preferred securities, if not called, generally represent a 30-year (or more) bullet maturity.

It is unsafe and unsound to buy long term securities from corporate issuers without appropriate controls over credit, interest rate and liquidity risks. Credit risks associated with trust preferred securities are especially high, given their long maturities, but occasionally receive inadequate attention from bank management. Some banks that would not consider purchasing 30-year Treasury securities due to their high interest rate risk have nevertheless purchased 30-year corporate debt because of the rich yields. Moreover, banks that have not documented that their unrated trust preferred holdings are the credit equivalent of investment grade have a violation of 12 CFR 1. Some banks have also failed to consider the price sensitivity of these securities or their impact on the bank's overall interest rate risk profile. Some trust preferred securities did not increase in value when interest rates declined, an indication of their generally poor liquidity.

National banks that purchase trust preferred securities must have appropriate prudential controls, including minimum quality and diversification requirements, and limits on the percentage of capital allocated to this asset class.

Equity-Linked CDs. Banks have begun to issue equity-linked CDs, a deposit instrument that provides a return linked to a major market index such as the S&P 500. Issuing banks typically hedge the risk of these deposits, i.e., the risk of paying an equity-linked return, through a swap transaction, often with a Federal Home Loan Bank.

Some banks have asked whether it is permissible to purchase, as investments, equity-linked CDs issued by other banks. These CDs may well provide diversification benefits to a bank investment portfolio, and they are permissible assets. However, they generally have poor liquidity and pose a number of complex accounting and tax issues. Investor banks will have to value the embedded call option on the market index, pursuant to Statement of Financial Accounting Standards No. 133 (Accounting for Derivative Instruments and Hedging Activities), and record changes in that value as a current period income or expense item. Moreover, the amount of income a bank can accrue on the instrument will be determined by the value of the call option at inception, which itself is a function of the volatility of equity prices. Additionally, investing banks will pay taxes on interest they have not received, which reduces the asset's effective yield.

National banks interested in purchasing equity-linked CDs should consider these instruments as new products and subject them to an internal risk management review that carefully evaluates the associated accounting, liquidity, credit, and operational risks. Because there is the potential to earn a zero economic return for the instrument's entire

life, national banks should adopt conservative limits on the volume of such assets.

Bank-Owned Life Insurance (BOLI). A number of banks have begun to use BOLI as a means of protecting against the loss of key employees or hedging employee compensation and benefit plans. As detailed more thoroughly in OCC Bulletin 2000-23, "Bank Purchases of Life Insurance: Guidelines for National Banks," dated July 20, 2000, banks purchasing BOLI must demonstrate and document a thorough understanding of the risks associated with this product.

Management must determine the need for insurance by identifying the specific risk of loss or obligation to be insured against, quantifying the amount of insurance needed, and performing a careful review of vendors and carriers.

In addition to the credit risk associated with this typically long tenor asset, BOLI presents potential volatility to earnings and capital due to liquidity and tax considerations. Although banks can surrender their BOLI policies for their cash surrender value, they typically would incur substantial losses to do so. Moreover, a determination that the policies do not satisfy insurable interest requirements may result in a forced cancellation, and/or jeopardize the tax-free status of the accumulation of cash surrender value, thereby negatively impacting the originally anticipated return. Because of heightened liquidity, credit and tax risks, purchasing or holding excessive BOLI represents an unsafe and unsound banking practice.

National banks should review their BOLI holdings to verify that the contracts are associated with a legitimate insurance need and divest those that are not.

RISK MANAGEMENT CONSIDERATIONS

With nominal interest rates at low levels, reinvestment decisions have significant implications for interest rate, liquidity, and credit risk management. The vast majority of 30-year mortgage assets (both loans and securities) held by banks have rates below 7.5 percent. Many banks that have purchased a disproportionate volume of securities at the low point in the yield cycle have significantly increased interest rate risk profiles. Should interest rates rise, as they have begun to do, earning asset portfolios may depreciate at accelerating rates, as the effective maturity of securities with options becomes longer. Banks that have taken on increased levels of interest rate risk without hedging protection will suffer from lost flexibility, diminished accounting earnings, and impaired economic value. Should economic conditions deteriorate further, the rising level of credit risks in investment portfolios may produce similar effects.

As banks contemplate investment strategies, they should carefully consider their risk tolerance. Given the long-term risks to earnings and capital from investment decisions made now, banks should not make strategic and policy changes to permit more aggressive risk profiles without careful consideration of their risk management capabilities. The Board of Directors should review the bank's risk management framework for investment risks and confirm that it provides appropriate controls over the current level of risk. The Board should also formally approve changes to policies and practices that permit increased risk tolerance. It is understandably difficult to reinvest cash flows from called or prepaid high yielding assets at today's low yields. However, for many banks it may be more prudent to accept somewhat lower than expected earnings for the near term in order to increase the likelihood of more favorable earnings for the long term. Banks should focus on long-term performance.

The importance of strong risk management controls over investing activities has rarely been more important than now. National banks should review the risk management disciplines (policies, guidelines, reporting procedures, etc.) governing their investment activities and make enhancements as needed. Banks must resist the temptation to cut costs by reducing risk management staff or postponing capital expenditures for risk management systems unless they have reduced risk tolerances to a commensurate level. An effective risk management program provides a critical first line of defense against potential problems.

SUPERVISORY REVIEW OF INVESTMENT ACTIVITIES

During examinations, OCC examiners will focus on the following issues highlighted in this bulletin:

1. Changes in the bank's risk tolerance and whether increases in tolerance have received appropriate board approval and are adequately supported by the existing risk management framework.
2. The longer term consequences, especially on capital adequacy, of the bank's current investment practices.
3. The extent and quality of the bank's internal credit analysis when purchasing securities that are non-rated, acquired under the bank's lending authority, or rated at the lower end of the permissible credit quality spectrum.
4. The volume of earning assets that have short embedded call options and the adequacy of the bank's controls and limits over economic risk exposures.
5. Whether the bank has considered the probable performance of securities in different interest rate and/or default scenarios.
6. The bank's documentation of legitimate insurance need where the bank reports bank-owned life insurance.

RESPONSIBLE OFFICE

Questions or concerns regarding this guidance should be directed to Kurt Wilhelm or Michael Drennan in the Treasury and Market Risk Division at (202) 874-5670.

Kathryn E. Dick
Director, Treasury and Market Risk Division