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Interpretation of Regulatory Guidance on Dodd Frank Investment Grade Due Diligence

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Seifried & Brew (S&B) provides relevant, dynamic content and services to the community banking industry. The S&B Municipal Bond Ratings use the fundamentals of bank credit analysis to meet regulatory compliance on new standards for investment grade due diligence. By reviewing regulatory guidance related to the Dodd Frank Wall Street Reform and Consumer Protection Act, this document discusses how and why community banks should use S&B as an independent third party to fulfill alternate standards of creditworthiness.

Dodd Frank and Wall Street Reform and Consumer Protection Act 939A

S&B states that credit risk is the "Mother of All Risk." Reliance on only the major credit rating agencies is not only bad policy, it proved detrimental for the banking industry and the economy during the Financial Crisis and Great Recession. In response, Congress passed the Dodd Frank and Wall Street Reform or Consumer Protection Act ("Dodd Frank"). Under section 939A of this legislation, Federal regulatory agencies are directed to remove references to, or reliance upon, the major rating agencies in regulations regarding credit assessment, including municipal bonds. In their place, community banks must follow "uniform standards of creditworthiness" to determine whether a bond is investment grade. Community banks are required to meet these standards in proportion to the size and exposure to risk each security in their portfolio.

Regulatory Agencies are gradually implementing Dodd Frank and are expected to demand greater due diligence over time. Community banks are encouraged to build on practices and procedures already in place. Independent third-party analysis can also be incorporated into investment policy and procedure to meet regulatory requirements. As community banks adapt to the requirements, S&B believes the industry will be safer and more knowledgeable in regard to credit risk.

Interpretation of Dodd Frank by Federal Agencies: OCC Guidance as Preliminary Direction

The OCC provided the initial guidance on Due Diligence requirements for investment grade determination in June of 2012 with a compliance date of Jan. 1, 2013. While the FDIC has added additional standards, the basic principles of the OCC guidance remain foundational and relevant. According to the OCC, community banks will be required to determine whether their investments are investment grade without relying or referencing external Nationally Recognized Statistical Rating Organization (NRSRO) credit ratings. Each community bank must develop its own alternate standards of creditworthiness in accordance with the risk profile of its investments.

The initial OCC guidance centered on the crucial definition of "investment grade":

- *"issuer has an adequate capacity to meet the financial commitments under the security for the projected life of the investment" (77 FR 35259)*
- *"the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected" (77 FR 35259)*
- *"full and timely repayment of principal and interest is expected over the expected life of the investment" (77 FR 35260)*

Are your securities investment grade? How well do you understand the security and sources of payment of each security? Municipalities must demonstrate a strong financial position and adequate financial management. Local demographics must also be understood. When purchasing securities, it is important to know: "Will this default over the life of the security?" Existing practices should be augmented to make this determination.

Implementation

Community banks can expect due diligence requirements to become gradually more demanding over time. Additionally, requirements will vary by region and agency. The FDIC has noted it is looking for "good-faith progress" and will show flexibility starting out. Implementing new procedures will take time and resources, but S&B asserts that policy should be put into practice as early as possible. One way to accomplish this is to consult with an independent third party, like S&B, specializing in credit analysis. Working solely with a broker for third-party analysis might be sufficient for now, but over time, regulators will likely require more independent due diligence.

Pre-purchase & Post-purchase Analytics

The OCC requires both pre-purchase and post-purchase due diligence. Community banks must determine whether a security is investment grade prior to its purchase and whether a security continues to meet this standard on an ongoing basis. While pre-purchase analysis should be a thorough and consistent process, ongoing review may vary based on the risk profile of the bond. Due diligence is required in proportion to the level of risk, size, and complexity of each bond and relative to a community bank's investment portfolio. For example, a bond without an agency rating might require additional reporting. S&B provides community banks with both pre-purchase and post-purchase analysis on municipal bonds.

FDIC guidance furthers the distinction between investment grade determination and ongoing credit assessment (Summer 2013). Whereas low-risk securities can be monitored on an ongoing basis, new purchases and high-risk securities should receive more attention. A third-party vendor like S&B can be instrumental in performing ongoing portfolio risk assessments and flagging potential high-risk securities based on its independent criteria. Still, community banks are required to decide whether to buy or sell securities. While community banks may include external ratings in their analytical process, the FDIC's goal is to remove the dependence on these ratings by using criteria discussed in this paper.

Investment Grade Standards, the Classification of Securities and S&B's Solution

In their most recent joint agreement, the FDIC, OCC, and Federal Reserve Board emphasize that the new standards of creditworthiness be grounded in the principles of credit analysis for other earning assets. Recent FDIC guidance applies the language for credit deterioration and credit loss to the investment grade determination of securities (FL-51-2013). A classification perspective of credit analysis leads to a systematic treatment of credit risk in securities using the classification method. S&B recognizes the effectiveness of this framework of fundamental credit analysis. With its extensive experience providing services to the banking industry and firsthand experience consulting with community banks, S&B is very familiar with the due diligence practices and regulatory classification of assets.

S&B has framed its Municipal Bond Rating Scale (APPENDIX B) in terms of the credit risk parameters found in a community bank loan credit scale. Similar to the most recent FDIC guidance, S&B uses its two lowest ratings, an S&B 3 and S&B 4, to monitor securities that have undergone impairment and are no longer considered to be investment grade. The S&B 4 rating is the lowest rating and is assigned to "impaired" and non-investment grade securities. The FDIC would determine S&B 4 securities to be "Substandard" or "Doubtful." The S&B 3 rating is an investment grade rating assigned to a security that should be watched closely due to significant weakness. The S&B 3 is divided into an S&B 3+, an S&B 3, and an S&B 3-. If an S&B 4 credit demonstrates overall financial improvement in the next fiscal year, it will be upgraded to the S&B 3 watch status, either an S&B 3- or an S&B 3. Generally, once the credits show strength after one year as an S&B 3 or S&B 3+ they may be upgraded a stronger S&B 2 rating.

Third-party Analytics: The Role of S&B

The implementation of new standards of creditworthiness by Community Banks will take a considerable amount of time and resources. Community banks will be developing policies expanding existing procedures and designating teams of employees to fulfill internal credit analytics. As an alternative, when S&B credit analytics are part of the process, less internal resources are needed and a vital independent perspective is gained. S&B began providing municipal bond analytics as a best practice well before the OCC issued its first guidance in 2012. It currently fulfills this role with a large group of clients, generating pre-purchase rating opinions and monitoring portfolios for existing securities.

S&B's background is in the fundamentals of community banking and credit analysis. In its guidance, the OCC advises community banks to proceed with due diligence on its securities using the "fundamentals of credit analysis" (77 FR 35260):

"The foundation of a fundamental credit analysis – character, capacity, collateral, and covenants – applies to investment securities just as it does to the loan portfolio" (77 FR 35260)

Founded by community bank directors, S&B conducts its credit analysis in a manner similar to the loan credit review process. S&B municipal bond ratings are also effective in the case of nonrated bonds, bonds that have lost a rating, bonds that have a split rating, or other bonds that have a high risk profile. S&B identifies several advantages in providing independent, third-party credit analytics:

1. Independent and third-party ratings: the importance of analysis independence from an investment broker, internal influence, or outside rating agency. S&B's process is independent and distinctive.
2. Cost-effective: Hiring an independent firm saves time and resources
3. Due diligence: Independent rating model tailored to meet regulatory requirements and expand standards of creditworthiness
4. Consistent: Rating model ensures consistent, objective ratings based on a quantitative model
5. Experience: S&B has reviewed thousands of credits and is familiar with a variety of types and in a variety of locations
6. Economic expertise
7. Mapping technology: S&B Geo Zones for portfolio concentration risk

S&B offers a suite of products to provide varying degrees of due diligence. S&B offers Pre-purchase products to meet the unique and time-sensitive demands of community bank managers interacting with their investment brokers. S&B is consulted for both short turnaround pre-purchase analysis, longer projects reviewing a part or entirety of a portfolio, or ongoing monthly or quarterly ratings. S&B's basic pre-purchase product provides its clients with an underlying credit score as well as the essential economic and demographic data for each issuer.

Post-purchase and the Importance of Annual Review

S&B's post-purchase product involves the S&B Municipal Bond Rating model with methodology outlined in Appendix A. This model provides a baseline investment grade determination for every bond in the client's portfolio (although some revenue and non-GAAP financial statements will not fit the model). Then, as new annual financial statements become available, S&B updates the rating with each financial statement. S&B has witnessed many municipalities, from school districts to cities; undergo a rapid change in financial condition. While the FDIC has emphasized varying the degree of analysis for certain securities with different risk profiles, S&B asserts the vital need of annual review. Given the economic and political climate of local governments and municipalities and changes to the way that these institutions are funded and the financial obligations that face them, S&B analyzes each bond on an annual basis in order to provide the most up-to-date understanding of the credit risk of each bond on an ongoing basis. Such an understanding provides community banks with a real-time understanding of their earning assets not available through other more infrequent and less in-depth credit analysis. S&B considers this method the best way for management to avoid situations of OTTI impairment.

S&B Ratings and the OCC Proposed Guidelines for Municipal Credit Analysis

While the exact method of investment grade investment analysis can vary from bank to bank, the OCC provides a rating matrix in the guidance that demonstrates key points of analysis for each type of security. For municipal government general obligations and revenue bonds (*77 FR 35261*):

- "Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality"
  - **S&B Market Valuation Add-on**
- "Confirm risk of default is low and consistent with bonds of similar credit quality"
  - **The S&B Municipal Bond Rating** ***is assigned by way of the*** **S&B Pre-purchase Analytics/Municipal Bond Rating Model** ***as an indicator of overall solvency and financial condition through a set of uniform S&B benchmarks.***
- "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 to the particular security"
  - **S&B Pre-purchase Analytics/Municipal Bond Rating Model** ***and financial indicator benchmarks focusing on capacity to increase revenues, manage expenses, and improve financial position, as well as maintain adequate liquidity levels.***
- "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"
  - **S&B Pre-purchase Analytics/Municipal Bond Rating Model** ***and financial indicator benchmarks, focusing on capacity to meet budgets, increase the annual tax levy in response to changes in tax base and augment property tax revenues with alternative revenue sources. Consider the impact of debt levels and pension obligations on financial position and capacity to support future changes to these liabilities.***
- "Understand local demographics/economics. Consider unemployment data, local employers, income indices, and home values"
  - **S&B Economic/Demographic Profile** ***assigns overall and component performance levels by comparing demographic characteristics to other counties and states across the nation.***

REVENUE ONLY

- "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
  - **S&B Pre-purchase Analytics/Municipal Bond Rating Model** ***focuses on financial indicator benchmarks used in other municipal securities, while also focusing on rate covenants and coverage of debt service through adequate revenue generation and cash flow.***

APPENDIX A: Guidance Papers

S&B has identified the following regulatory guidance articles released by the OCC and FDIC to implement new standards of creditworthiness. These documents represent an evolution of interpretation, and S&B believes that any future documents will likely modify this former guidance:

- "Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment - Office of the Comptroller of the Currency" 12 CFR Parts 1 and 160
- "Alternatives to the Use of External Credit Ratings in the Regulations of the OCC" 12 CFR Parts 1, 5, 16, 28 and 160
- "Credit Risk Assessment of Bank Investment Portfolios" – FDIC Supervisory Insights Summer 2013
- "Uniform Agreement on the Classification and Appraisal of Securities Held by Financial Institutions" FDIC FL-51-2013, Oct. 29, 2013

APPENDIX B: Municipal Bond Ratings Methodology

S&B's Primary Due Diligence is based on each municipality's capacity for financial management. This capacity for financial management will impact its underlying credit risk as well as its ability to fund its long-term debt. In order to analyze financial management, S&B has developed a robust proprietary model to quantitatively assess key aspects of its operations. The model uses financial data inputted from the financial statements for each issuer. The model weighs a variety of financial indicators that S&B has found to be critical for an issuer's long-term solvency. These indicators also reflect an issuer's ability to function as a local government. For those credits exhibiting a strong credit profile under past evaluation by S&B, the rating model may be supplanted by a manual review incorporating many of the same indicators.

S&B identifies strong financial management as primarily the ability of the municipality to adapt and adjust its revenue streams and manage expenses in response to gradual or sudden changes in operations. Management is also reflected in its ability to set budgets that provide for these changes in operations and to properly levy the necessary taxes or charges to generate revenue sufficient to meet debt service payments. If one primary revenue source decreases, the municipality must have the capacity to take advantage of other revenue sources at its disposal.

The S&B Municipal Rating model weighs a variety of financial indicators using benchmarks developed by S&B to derive an overall score. Rate of change indicators are evaluated on an annual and a long-term basis. A variety of financial ratios are utilized depending on the type of bond. Certain financial indicators are given a stronger weight than others for the overall score. The model's overall score is the primary determinant for each rating reviewed by each analyst. The model also provides multiple years of analysis for each analyst to better understand the information provided in the financial statements.

Additionally, S&B reviews the essential socioeconomic data for the county and state, relevant to each municipality, with a focus on those bonds with a weak financial outlook. The analyst seeks to identify demographic trends that could impact the revenue capacity of the municipality.

APPENDIX C: S&B Municipal Bond Ratings

The S&B Ratings are delineated as:

- S&B 1: the municipality will pay interest and principal as expected
- S&B 2: the municipality will pay interest and principal as expected, but the municipality's financials are indicating a warning sign with some financial weakness
- S&B 3: indicates continued weakness in a municipal credit
- S&B 4: indicates concern that the municipality may have problems paying principal and interest as expected

For a typical community bank, both the S&B 1 and S&B 2 would most likely be graded a "2" loan credit. If the credit is an essential purpose general obligation or revenue issuer and rated an S&B 3, it would most likely be graded a "3" loan credit. The S&B 1, 2, and 3 ratings are considered to be investment grade, while an S&B 4 is not considered to be investment grade and would be considered impaired or "substandard."

A rating with a "+" indicates that the rating was strong within its respective S&B rating number, but not strong enough to be at the next highest rating. A rating with a "-" indicates that the rating was weak within its respective S&B rating number, but not weak enough to be at the next lowest rating. These gradations are not to be construed as indications of future movement in the rating.