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**Office of the Comptroller of the Currency  
Board of Governors of the Federal Reserve System  
Federal Deposit Insurance Corporation**

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**Uniform Agreement on the Classification and Appraisal of Securities Held by  
Depository Institutions (Agreement)**

**October 29, 2013**

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC), (collectively, the agencies) are issuing this joint Agreement to depository institutions<sup>1</sup> to revise the 2004 *Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts* (2004 Agreement).<sup>2</sup> These revisions replace references to credit ratings with alternative standards of creditworthiness consistent with sections 939 and 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Accordingly, this Agreement applies creditworthiness standards adopted in 2012 to the classification of securities and removes the reliance on credit ratings as a determinant of classification.<sup>3</sup> Specific examples are illustrated to demonstrate the appropriate application of these standards to the classification of securities. This Agreement should be used by depository institutions to assist and facilitate the classification of investment securities.

## **I. The Classification of Assets in Depository Institutions**

The agencies' longstanding asset classification definitions have not changed and are provided in the Attachment to this Agreement. This Agreement clarifies how the unique characteristics exhibited by investment securities are to be interpreted within these classification categories.

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<sup>1</sup> For the purposes of this guidance, "depository institutions" include: national banks, state-chartered banks, and state- and federally-chartered savings associations.

<sup>2</sup> For the OCC, refer to Bulletin 2004-25, "Uniform Agreement on the Classification of Securities." For the Board, refer to SR letter 04-9, "Revised Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts." For the FDIC, refer to Financial Institution Letter FIL-70-2004, "Interagency Policy on Classification of Assets and Appraisal of Securities."

<sup>3</sup> For the OCC's final rules, see 77 *Fed. Reg.* 35253 (June 13, 2012). For the OCC's guidance, see 77 *Fed. Reg.* 35259 (June 13, 2012) and OCC Bulletin 2012-18 and OCC Bulletin 2012-26. For the Board, refer to SR letter 12-15, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings." For the FDIC, see Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities, 77 *Fed. Reg.* 43151 (July 24, 2012) and Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security is Eligible for Investment, 77 *Fed. Reg.* 43155 (July 24, 2012).

## II. The Appraisal of Securities in Depository Institutions

Fundamental credit analysis is central to understanding the risk associated with all assets and should be applied to investment securities as part of a pre-purchase and ongoing due diligence process, as discussed in regulatory guidance. Depository institutions are expected to perform an assessment of creditworthiness that is not solely reliant on external credit ratings provided by Nationally Recognized Statistical Rating Organizations (NRSRO). Such an assessment may include internal risk analyses and a risk rating framework, third-party research and analytics (which could include NRSRO credit ratings), default statistics, and other sources of data as appropriate for the particular security. The depth of analysis should be a function of the security's risk characteristics, including its size, nature, and complexity. Individual security analysis should form the basis of any classification determination.

### A. Investment grade debt securities

A security is investment grade if the issuer of the security has an adequate capacity to meet financial commitments for the life of the asset.<sup>4</sup> An issuer has adequate capacity to meet its financial commitments if the risk of default is low, and the full and timely repayment of principal and interest is expected.<sup>5</sup> A “pass” rating may be supported by an appropriate credit analysis that documents the quality of an investment grade security, as well as ongoing analyses that demonstrate the obligor's continued repayment capacity. Therefore, investment grade securities will generally not be classified. However, examiners may use discretion to classify a security when justified by available credit risk information.

### B. Sub-investment grade debt securities

Securities that do not meet the investment grade standard, as defined in applicable regulations, and for which the timely repayment of principal and interest is not certain, have investment characteristics that are distinctly or predominantly speculative and are generally

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<sup>4</sup>To determine whether a security to be acquired for investment must be investment grade and the applicable definition of “investment grade,” a bank or savings association should consult the regulations of its appropriate federal banking agency, e.g., national banks should look to the OCC's rules at 12 CFR part 1. For state-chartered financial institutions, the term “investment grade” may be defined differently across laws and regulations issued by each state, and therefore may be subject to restrictions on investments that are more stringent than those in 12 CFR part 1. In addition, for corporate investments, federal and state savings associations are required to determine if the security meets the investment permissibility standards under 12 CFR Part 362 of the FDIC Rules and Regulations. 12 CFR Part 362 requires that the issuer has adequate capacity to meet all financial commitments under the security for the projected life of the investment. This standard is consistent with the one adopted by the OCC for national banks defined in 12 CFR part 1, which was revised to replace the previous definition of “investment grade.” State and federal savings associations had to comply with the FDIC's final rule on January 1, 2013. See *77 Fed. Reg.* 43151 (July 24, 2012). Under the Federal Reserve Act (12 USC 335) and the Federal Reserve's Regulation H (12 CFR 208.21), state member banks are subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as national banks under the National Banking Act (12 USC 24 (Seventh)) and may only invest in securities to the extent permitted under applicable state law.

<sup>5</sup> See, e.g., 12 CFR 1.2(d). Generally, assets that defer payments, even if allowed for in the instrument's contracts, do not meet the “full and timely” repayment standard for investment grade and typically should be classified.

subject to classification. For investment securities, the classification should be based on the instrument's worth as an earning asset assuming it is held to maturity. Therefore, the phrase "liquidation of the debt" in the classification definitions is synonymous with "payment of the obligation in full." Accordingly, if payment of the obligation in full is in question, it is no longer investment grade and management should classify the security.

A Doubtful classification is appropriate when an asset has experienced significant credit deterioration and decline in fair value, but estimation of impairment involves significant uncertainty because of various pending factors. These factors could include uncertain financial data that may not permit the accurate forecasting of future cash flows or estimating recovery value. The use of the Doubtful classification is an interim measure until information becomes available to substantiate a more appropriate treatment.

#### C. Classification and assessment of other types of debt securities

Some securities with equity-like risk and return profiles can have highly speculative performance characteristics. When determining classification examiners should evaluate such holdings based upon an assessment of each instrument's facts and circumstances. This Agreement does not apply to securities held in trading accounts that are measured at fair value with changes in fair value recognized in current earnings and regulatory capital.<sup>6</sup>

#### D. Classification of securities with credit deterioration

Depository institutions should continually assess whether securities meet the investment grade standard. Throughout the term of an investment security, its credit risk profile can decline and improve as credit conditions change. Similarly, an institution's analysis should consider how potential adverse economic conditions can negatively affect an individual security. An institution's management expertise and the sophistication of its risk management and due diligence processes should be commensurate with the complexity of its investment portfolio holdings.

##### *For securities already owned:*

Depository institutions should classify a security to accurately reflect its credit risk profile. For example, a security may meet the criteria for an investment grade rating at purchase and, therefore, be considered a "pass" security. However, as credit conditions deteriorate and ongoing analysis confirms a weakened repayment capacity, the security should be downgraded to Substandard or Doubtful. In situations where the credit condition subsequently improves, the facts and circumstances supported by current analysis may warrant an upgrade to "pass." An upgrade is only appropriate following a

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<sup>6</sup> For more information, please refer to the Glossary section of the FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income, which can be found at the following URL address: <http://www.fdic.gov/regulations/resources/call/>.

period of sustained performance. If the security incurs credit losses,<sup>7</sup> but subsequent analysis shows that all future contractual payments will be received, the security may warrant an upgrade to “pass.” Notwithstanding this possibility, securities with realized credit losses do not conform to the investment grade standard and may be subject to restrictions under the agencies’ permissible investment regulations or rules governing transfers to affiliates. In situations where credit losses are incurred and analysis does not support the full payment of future contractual amounts, the security cannot be upgraded to “pass.”

*For potential purchases:*

Depository institutions may not purchase investment securities that fail to meet the investment grade standard as defined by applicable regulations. If pre-purchase analysis reveals previous credit losses in a security under consideration, regardless of its current performance or projected payment analysis, the security does not, and cannot, meet the investment grade standard.<sup>8</sup> In contrast, if a security experienced credit deterioration and downgrades in the past, but did not sustain actual credit losses, the security’s current and projected payment performance may indicate that the security could meet the investment grade criteria once more. If it is offered for sale at this point and has a history of sustained performance, this security would be considered eligible for purchase by a depository institution.

### **III. Classification Approach Examples**

The table that follows outlines examples of how the agencies would apply the uniform classification approach to specific situations. Examiners may use discretion to assess credit risk and assign a classification based on current information, independent of any assigned credit rating.

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<sup>7</sup> Credit losses can occur throughout various stages of a security’s existence and will depend on a variety of factors, that is, the type of instrument, the ability of the underlying payment source (for example, issuer, underlying asset, and obligors), and the existence of guarantees or credit enhancements. For corporate and municipal obligations, credit losses may represent payment defaults that the issuer does not have the financial capacity to cure. In the case of structured finance products, if a particular class of securities or tranches is no longer fully supported by cash flows from underlying assets, credit losses represent the deficiencies between remaining available cash flow and the principal and interest requirements.

<sup>8</sup> One exception to this rule is a security that has undergone a court-supervised legally binding restructure, which has performed for a sustained period following the restructure. This scenario is discussed further in the examples table.

| Description of Scenario   | Currently Owned    | Potential Purchase <sup>9</sup>            |
|---|--------------------|--|
| <ul style="list-style-type: none"> <li>• Credit deterioration caused concerns about potential loss that led to a Substandard classification.</li> <li>• <b>Credit deterioration is considered temporary.</b></li> <li>• Subsequently, the credit condition improved and prior concerns no longer exist.</li> <li>• No actual credit losses were sustained.</li> <li>• Security has performed as agreed to date and is expected to perform to maturity.</li> </ul>   | Upgrade to “pass.” | Eligible for purchase as investment grade. |
| <ul style="list-style-type: none"> <li>• Credit deterioration caused concerns about potential loss that led to a Substandard classification.</li> <li>• <b>An other-than-temporary impairment (OTTI) charge is recognized in earnings; however, all contractual payments were received.</b></li> <li>• Subsequent to adverse classification / OTTI determination, the credit condition improved and prior concerns no longer exist.</li> <li>• Current analysis shows that all future contractual payments will be received.</li> </ul> | Upgrade to “pass.” | Eligible for purchase as investment grade. |

<sup>9</sup> Depository institutions contemplating an investment purchase are not expected to be knowledgeable of the classification and impairment accounting treatment by the seller. However, all salient information leading to investment grade determination should be gathered and analyzed before a purchase is consummated.

| Description of Scenario   | Currently Owned   | Potential Purchase <sup>9</sup>   |
|---|---|---|
| <ul style="list-style-type: none"> <li>• Credit deterioration caused concerns about potential loss that led to a Substandard classification.</li> <li>• <b>An OTTI charge is recognized in earnings; however, contractual payments are received after recognition of the OTTI charge.</b></li> <li>• Subsequently, credit conditions remain weak and analysis shows that <b>not all</b> contractual payments are expected to be received.</li> </ul>  | <p style="text-align: center;">Substandard classification remains until issuer demonstrates adequate capacity to repay.</p>   | <p style="text-align: center;">Not eligible for purchase as long as current credit conditions remain.</p>                           |
| <ul style="list-style-type: none"> <li>• Credit deterioration caused concerns about potential loss that led to a Substandard classification.</li> <li>• <b>Credit losses actually incurred.</b></li> <li>• A court supervised a legally binding restructure of the obligation.</li> <li>• The issuer demonstrated performance, after the restructure, in accordance with the court approved plan over an appropriate time period. Current analysis shows that <b>all</b> future contractual payments will be received.</li> </ul> | <p style="text-align: center;">Upgrade to “pass” after a period of satisfactory performance.</p>  | <p style="text-align: center;">Eligible for purchase as investment grade subsequent to the restructure.</p>                         |
| <ul style="list-style-type: none"> <li>• Credit deterioration caused concerns about potential loss that led to a Substandard classification.</li> <li>• <b>Credit losses actually incurred.</b></li> <li>• Subsequently, the credit condition improved and prior concerns no longer exist.</li> <li>• Subsequent analysis shows that <b>all</b> future contractual payments will be received.</li> <li>• Previously incurred credit losses may or may not be recovered.</li> </ul>  | <p style="text-align: center;">Substandard classification remains until issuer demonstrates adequate capacity to repay based on sustained period of performance.</p> <p style="text-align: center;">May be upgraded to “pass” but is not investment grade; considered a nonconforming investment.</p> | <p style="text-align: center;">Not eligible for purchase; does not meet the criteria for investment grade due to credit losses.</p> |

| Description of Scenario  | Currently Owned  | Potential Purchase <sup>9</sup>   |
|--|--|---|
| <ul style="list-style-type: none"> <li>• Credit deterioration caused concerns about potential loss that led to a Substandard classification.</li> <li>• <b>Credit losses actually incurred.</b></li> <li>• Subsequently, credit condition stabilization may, or may not, be evident.</li> <li>• Subsequent analysis shows that <b>not all</b> future contractual payments will be received; or analysis does not clearly show no future risk of loss.</li> </ul> | <p>Classification remains as long as credit analysis indicates future potential losses. Determine appropriate classification based on credit analysis.</p> | <p>Not eligible for purchase; does not meet the criteria for investment grade due to credit losses.</p> |

Note: Any upgrade in classification should follow a sustained period of performance and be based on improvement in credit condition and analysis that supports all future contractual payments will be received. Generally, the performance period should cover multiple payments as determined by the security’s payment structure: monthly, quarterly, annually.

## **Attachment 1**

### **Classification Definitions**

The following definitions apply to assets adversely classified for supervisory purposes:

- A **Substandard** asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.
- An asset classified **Doubtful** has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
- Assets classified **Loss** are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.