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Beyond Dodd-Frank: Strategies for Effective Risk Management of the Investment Portfolio

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Under the Dodd-Frank Act, financial institutions must maintain risk management processes to ensure that credit risk in the investment portfolio is effectively monitored and controlled, but they may wish to have procedures in place which go beyond the regulatory mandates, in order to further mitigate risk and enhance profitability.

The financial crisis exposed deficiencies in credit ratings assigned by nationally recognized credit rating agencies for fixed-income securities, especially for products tied to real estate. According to the FDIC, some banks did not adequately understand or independently assess the risk characteristics of a bond's obligor, the underlying collateral, or the payment structure of individual securities.

The regulator said inadequate due diligence led to purchases of securities that were believed to be "investment-grade" bonds. This turned out not to be the case in many instances, as initial credit ratings failed to recognize repayment risks and weaknesses that were exposed when the economy deteriorated.

The reliance on credit ratings prompted Congress to enact the Dodd-Frank Act, which among other things, restricted references to credit ratings in banking regulations. In response, the OCC issued *Alternatives to the Use of External Credit Ratings* and accompanying guidance that established a new investment-grade standard. The rule requires banks to verify that their investment securities meet this standard at purchase. The rule defines "investment grade" as a security with a low risk of default and where full and timely payment of principal and interest is expected.

Even before the financial crisis, existing guidance required that financial institutions have in place a robust credit risk management framework which integrated appropriate pre-purchase analysis and ongoing monitoring that graded a security's credit risk based on the repayment capacity of the issuer and the characteristics of a security. The supervisors' emphasis changed with Dodd-Frank as examiners shifted their focus to the adequacy of the pre-purchase analysis and monitoring procedures, rather than on the credit ratings.

In subsequent guidance, the FDIC reiterated that banks must have a sufficient understanding of the credit risk of investment securities to ensure that requirements for safety and soundness are observed and maintained. Surprisingly, they did not issue specific guidance detailing procedures for separate instruments. By keeping the guidance broad, the regulators aimed to give bankers flexibility to customize due diligence procedures to fit their individual situation. Without specific guidelines, however, many financial institutions were left wondering what items ought to be part of the initial due diligence package.

While Dodd-Frank dealt mainly with credit standards, the Act also stipulates that management fully understand safety and soundness standards related to interest rate risk, liquidity risk and other factors. Accordingly, financial institutions should incorporate the following to help document the investment decision:

- Security description
- Price volatility
- Initial credit spread
- List of risk factors considered
- Narrative of investment rationale
- Evaluation of key ratios
- Verification of compliance to policy limits
- Itemization of financial reports obtained
- Credit ratings

Management needs to "tie together" the analysis to determine whether the overall risk profile of the security is suitable for the institution. The analysis and conclusions should be documented to demonstrate to the examiner that the security meets the investment grade standard.

In its policy statement on investment securities, the FDIC says institutions should have programs in place to manage the risks of investment securities and investment activities. These elements include a comprehensive risk management process that effectively identifies, measures, monitors and controls risk.

Robust reporting is an essential part of this process and can serve several useful purposes. To ensure its oversight responsibilities, the board of directors should review portfolio activity and risk levels, and require management to demonstrate compliance with approved risk limits. Management should provide timely and adequate information about investment activities to inform stakeholders about the changing nature of the institution's risk profile. Bankers are familiar with watch-list reporting for commercial loans, and a similar system may be helpful to track investment securities that may potentially pose higher risk. This type of reporting can provide a mechanism for escalating reviews or implementing action plans for deteriorating credits or underperforming securities, and exceeds the Dodd-Frank requirements.

The following are a few items bankers can track in order to anticipate potential problem situations. These are securities exhibiting:

- Acceleration in prepayment speeds
- Notable extension risk
- Large and persistent market value declines
- Unusual increase in credit spread
- Deterioration in financial situation
- Large change in book yield

Management should note variances in the above factors relative to those that existed at time of purchase. In addition, current trends can be observed for signals about weakening performance.

The investment policy provides the structure to effectively manage investment activities. Policies should identify guidelines for the acquisition and ongoing management of securities, as well as action plans for underperforming securities.

Management should ensure that the investment policy accurately reflects the due diligence practices being conducted for each applicable security, while review procedures should be in line with outstanding regulatory guidelines.

Disclaimer: The views and opinions expressed in this article are those of the author(s) and do not necessarily reflect the official policy or position of the Financial Managers Society.

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