

October 25, 2010

BY ELECTRONIC MAIL

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219

Re: Advance Notice of Proposed Rulemaking on Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 75 *Federal Register* 49423, August 13, 2010

Docket No. 2010-0017; RIN 1557-AD36

Dear Sir or Madam:

The American Bankers Association (ABA)¹ and the ABA Securities Association (ABASA)² appreciate the opportunity to comment on the advance notice of proposed rulemaking (ANPR) issued by the Office of the Comptroller of the Currency (OCC) pursuant to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act³ (Dodd-Frank Act) that would remove from its regulations any reference to or requirements of reliance on credit ratings and to substitute alternative standards of creditworthiness. OCC has identified references to credit ratings in its regulations at 12 CFR Part 1 on investment securities, 12 CFR Part 16 on securities offerings by national banks, and 12 CFR Part 28 on international banking activities. Most of ABA's members are banks that are subject to these OCC regulations.⁴

While we recognize that inadequacies in the issuance and use of credit ratings contributed to recent financial disruptions in the U.S. markets, we believe that a complete abandonment of credit ratings is ill-advised and an over-reaction. Other provisions of the Dodd-Frank Act and changes in industry practice render unnecessary the complete abandonment of credit ratings as one option out of a number of possible indicators of creditworthiness. These changes include the following:

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$13 trillion banking industry and its 2 million employees. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities.

² ABASA is a separately chartered affiliate of the ABA that represents those holding company members of the ABA that are actively engaged in capital markets, investment banking, and broker-dealer activities.

³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

⁴ The OCC's investment securities regulations apply to state-chartered banks under 12 U.S.C. 1831a.

- Section 932 of DFA requires the credit rating agencies to provide more extensive and enhanced disclosure of their methodologies and to take actions to mitigate potential conflicts of interest.
- The SEC is required to establish an Office of Credit Ratings to protect users of credit ratings, promote accuracy in ratings, and ensure that ratings are not impacted by conflicts of interest.
- Title IX of DFA imposes new liability standards on rating agencies, including a private right of action for securities law violations.

In addition, the industry has taken pro-active measures to improve practices criticized in the recent financial market disruptions. For example, we understand that improvements to credit rating methodologies are being made and that incentive structures for rating agencies are changing. Based on recent press reports from the rating agencies, they have adopted new corporate governance procedures, enhanced controls for managing potential conflicts of interest, and new analytical tools.⁵ These developments should allow for continued regulatory reliance on credit ratings.

If the OCC believes it must abandon completely the use of credit ratings in its rules, we offer specific suggestions for an alternative approach in our Discussion of Specific Questions Presented in the ANPR.

Background

Investment Securities Regulations

OCC's investment securities regulations at 12 CFR Part 1 prescribe standards under which banks may purchase, sell, deal in, underwrite, and hold securities consistent with safe and sound banking practices. Investment securities are defined as marketable debt obligations that are not predominantly speculative in nature. A security is not predominantly speculative if it is rated investment grade or, if unrated, the credit equivalent of a security rated investment grade. An investment grade security is one rated in one of the four highest rating categories by two or more nationally recognized statistical rating organizations (NRSROs) or one NRSRO if the security has been rated only by one such organization. The OCC uses NRSRO ratings as a factor for the permissibility of bank investments as well as appropriate concentration levels of different classes of investment securities that a bank may purchase, sell, deal in, underwrite, and hold.

The ANPR offers three options for alternatives to the use of credit ratings for determining the permissibility of investment securities.

- *Credit quality-based standard.* OCC could adopt standards similar to those currently used for assessing the credit quality of unrated securities, such as requiring banks to perform an internal credit assessment and analysis demonstrating that the security is a strong

⁵ See, e.g., www.standardandpoors.com/about-sp/leadership-actions.

“pass” asset under the bank’s internal credit rating standards. The OCC could require the bank to document that the issuer—

- Has adequate capacity to meet its financial commitments;
- Is subject only to moderate credit risk; and
- Has low current default expectations.

This analysis would be subject to examiner review and classification. OCC notes that banks would still be expected to understand and manage the price, liquidity, and other risks associated with the securities.

- *Investment quality-based standard.* OCC could adopt a broader investment quality standard that, in addition to creditworthiness elements, would add an assessment of the securities’ marketability, liquidity, and price risk associated with market volatility. Under this standard, a security with a low probability of default may nevertheless be deemed predominantly speculative in nature due to the presence of significant liquidity or market risk. There would be documentation and review requirements similar to the credit quality-based standard.
- *Internal risk ratings.* OCC could adopt a creditworthiness standard based on the bank’s internal risk rating systems, subject to documentation and review. This would be similar to current treatment of unrated securities.

Securities Offerings

OCC’s rules for registration of securities issued by national banks provide for an abbreviated registration system for “investment grade” securities. The agency designed that system to ensure that potential purchasers of nonconvertible debt have access to necessary information on the issuing bank and commonly controlled depository institutions, as well as the appropriate knowledge and experience to evaluate that information. OCC also notes that its rules are cross-referenced to the SEC registration rules that may themselves contain references to ratings. The SEC is also required to remove references to credit ratings from its rules, and OCC will consider any of the changes the SEC may make when revising the bank registration requirements.

International Banking Activities

Under the International Banking Act, 12 U.S.C. 3102(g), foreign banks with federal branches or agencies must establish and maintain a capital equivalency deposit (CED) with a member bank located in the state in which the branch or agency is located. Assets that are eligible for inclusion in a CED include certificates of deposit, payable in the United States, and banker’s acceptances, provided that the issuer or investment is rated investment grade by an internationally recognized rating organization (IRRO) and no IRRO has rated the issuer or the investment lower than investment grade.

General Discussion

Our members have expressed a consensus view that the inability to use credit ratings even as one factor in assessing the creditworthiness of an investment is unworkable. They believe that without a standard set of market-accepted parameters, such as is provided by the rating agencies, banks will be at risk of being criticized by examiners after the fact when their judgments about the same security differ.

Moreover, banks of all sizes will be constrained by the number of securities they can review, likely leading to greater concentrations in a smaller range of investments. Issuers will also be impacted by the pullback in bank investments when community banks are unable to participate, for example, in a local project, because they cannot perform the necessary credit assessments.

The inability to use credit ratings in evaluating investments would disadvantage our community and regional bank members when compared with larger institutions that have advanced analytical capabilities. In addition, our larger members who operate globally are concerned that they will be disadvantaged when compared to their international counterparts who may continue to use external credit ratings.

Discussion of Specific Questions Presented in the ANPR

1. In some cases the regulations described in the ANPR use credit ratings for purposes other than measuring creditworthiness (for example, the definition of “marketability” at 12 CFR 1.2(f)(3). Should the Dodd-Frank Act’s requirement for the removal of references to credit ratings be construed to prohibit the use of credit ratings as a proxy for measuring other characteristics of a security, for example, liquidity or marketability?

It is important to link the use of credit ratings in the OCC’s regulations with the intended use and purposes of such ratings as expressed by the rating agencies. Standard & Poor’s notes on its website⁶ that it issued several requests for comments from market participants about providing commentary and analysis on non-default risks. In response to the input received from market participants, S&P has decided to adopt criteria to address ratings stability and volatility but has declined to adopt criteria to address directly market liquidity. The OCC should proceed carefully in the use of credit ratings for non-default risks and use ratings only when both the rating agencies and regulators believe that they are fit for a particular purpose. This will help avoid some of the problems related to the use of ratings that were revealed in the recent financial market disruptions.

- 2a. If continued reliance on credit ratings is permissible for purposes other than creditworthiness, should the OCC permit national banks to continue to use credit ratings in their risk assessment process for the purpose of measuring the liquidity and marketability of investment securities, even though alternative measures to determine creditworthiness would be prescribed?

Please see answer to Question 1, above.

⁶ www.standardandpoors.com/about-sp/leadership-actions.

2b. What alternative measures could the OCC and banks use to measure the marketability and liquidity of a security?

As noted above, it is important to recognize that credit-based standards may not be appropriate to capture non-credit risks such as marketability and liquidity. We believe that part of the problem that led to a lack of reliance on credit ratings was the use of those ratings for purposes for which they were not designed.

For publicly traded securities, market information, such as trading volumes, number of trading venues and market makers, the existence of secondary or derivatives markets for the security, and whether the security is eligible collateral or can be margined with relatively modest haircuts could be indicative of marketability and liquidity. The depth, level of concentration, and level of interconnectedness of participants in the market for a specific security can also be indicative of marketability and liquidity but may be more difficult to evaluate and track. For non-publicly traded securities, evidence of active and ongoing sales and secured funding or securitization of the security could indicate marketability and liquidity.

3. What are the appropriate objectives for any alternative standards of creditworthiness that may be used in regulations in place of credit ratings?

Please see answer to Question 4, below.

4. In evaluating potential standards of creditworthiness, the following criteria appear to be most relevant; that is, any alternative to credit ratings should:

- a. foster prudent risk management;
- b. be transparent, replicable, and well defined;
- c. allow different banking organizations to assign the same assessment of credit quality to the same or similar credit exposures;
- d. allow for supervisory review;
- e. differentiate among investments in the same asset class with different credit risk; and
- f. provide for the timely and accurate measurement of negative and positive changes in investment quality, to the extent practicable.

Are these criteria appropriate? Are there other relevant criteria? Are there standards of creditworthiness that can satisfy these criteria?

We believe that these criteria are appropriate. Standards of creditworthiness other than credit ratings that can satisfy these criteria could include historical performance and market data, which can be incorporated into a standardized approach or into banks' internal credit risk assessment models.

5. The OCC recognizes that any measure of creditworthiness likely will involve tradeoffs between more refined differentiation of creditworthiness and greater implementation burden. What factors are most important in determining the appropriate balance between precise measurement of credit risk and implementation burden in considering alternative measures of creditworthiness?

We would encourage the OCC to consider a range of options for banks to use in measuring creditworthiness, with a bank selecting either a standardized approach or an advanced approach for all transactions for which credit ratings currently may be used. A standardized approach could be based on the assignment of different classes of securities to investment limitations, much like the current approach. The assignment could be based on a variety of factors – in addition to credit ratings, the historical performance of the class of security or average credit spreads could be possible determinants. An advanced approach based on internal bank models could be made available for banks with more sophisticated risk management capabilities – subject, of course, to supervisory review. The advanced approach could be similar to the standards described under the credit quality-based standard in the ANPR.

A range of options will allow individual banks to strike the appropriate balance between precision of measurement and implementation burden. Some banks may favor a less nuanced approach in favor of a “broad-brush” standardized approach that may, on average, produce more restrictive investment limitations but, at the same time, reduce burden and cost. Other banks may favor an approach that is more precise and reflects more accurately the particular holdings in the bank’s portfolio. Banks will have different reasons for adopting different approaches: the importance of the investment portfolio to bank profitability, cost considerations, and management resources.

6. Would the development of alternatives to the use of credit ratings, in most circumstances, involve cost considerations greater than those under the current regulations? Are there specific cost considerations that the OCC should take into account? What additional burden, especially at community and regional banks, might arise from the implementation of alternative methods of measuring creditworthiness?

At the outset, we do not believe that the OCC is required by statute to abandon completely the use of credit ratings in their regulations. Rather, credit ratings could be one of several factors used to determine the creditworthiness of an investment, security, or other asset. The Dodd-Frank Act does not preclude the use of third party analytics by banks, including credit ratings. Of course, these analytics should be validated by a bank’s own due diligence.

In general, we believe that the development of alternatives to the long-standing use of credit ratings would involve cost considerations greater than those under current regulation, without a corresponding benefit to risk management. Whenever a bank is required to adopt different criteria for managing its assets, it must alter existing systems, retrain staff, and revise policies and procedures. These changes involve cost and burden in the form of staff and management time. Some banks will need to outsource the development of new systems, adding to cost burdens.

While cost and burden would be a factor for all banks, it is likely to be more pronounced for community and regional banks that may not have in-house the systems and management capabilities to convert to new standards. A cost-effective, simple standardized approach is particularly important for these banks if it is determined necessary to abandon the use of credit ratings.

7. The credit rating alternatives discussed in this ANPR differ, in certain respects, to those being proposed by the OCC and the other federal banking agencies for regulatory

capital purposes. The OCC believes such distinctions are consistent with current differences in the application and evaluation of credit quality for evaluating loans and investment securities and those used for risk-based capital standards. Are such distinctions warranted? What are the benefits and costs of using different standards for different regulations?

If both the investment and risk-based capital regulations are based on the creditworthiness of specific assets or classes of assets, we do not understand why a broadly similar approach cannot be adopted for both sets of regulations. In our comment on the ANPR on the use of credit ratings for the risk-based capital rules, we suggested that a standardized approach might be appropriate for banks that do not or cannot elect an internal models-based approach. This standardized approach could be adapted for both sets of regulations, allowing banks to use a broadly similar methodology for investment allocation and capital adequacy purposes. Banks with more sophisticated modeling capabilities could use a similar internal credit model for both sets of regulations. This would minimize burden and cost while meeting the goals of both sets of regulations – that is, basing investment limitations and the capital needed to be held against the risk of those investments on the relative creditworthiness of different investments or classes of investments.

8. What are the advantages and disadvantages of the alternative standards described in the *Supplementary Information*?

Credit Quality-Based Standard. A credit quality-based standard would require banks to document, through their own credit analysis and assessment, that the security meets specified internal credit rating standards – for example, an internal rating of “pass.” Banks are required to have the ability to internally rate loans and investments, using methodologies and systems that are appropriate for the size and complexity of the bank and the complexity of its investment activities. A credit quality-based standard would continue existing bank risk management requirements and should not create undue burden or cost to banks. This approach could be the basis for a standardized approach to assessing the creditworthiness of investment securities under 12 CFR Part 1.

Investment Quality-Based Standard. This approach would establish criteria for marketability, liquidity, and price risk associated with market volatility, in addition to criteria for creditworthiness in determining whether, and to what extent, a bank may invest in a given security or class of security. This approach has the advantage of considering a broader range of risks that impact the ultimate value of a security, rather than relying simply upon credit risk. However, it would be difficult to develop a standardized approach that takes into account this wider range of variables. Therefore, adoption of this standard could create significant issues of cost and burden for banks that do not have internal modeling capabilities for market, liquidity, and other risks. Indeed, the ANPR points out that the risks of certain securities are not well captured by standardized financial modeling techniques.

Reliance on Internal Risk Ratings. This approach would rely on a bank’s internal risk rating systems using systems and criteria similar to the bank’s internal loan rating system. This approach has the advantage of using existing bank systems as the basis for analyzing whether and to what extent a bank can invest in a given security or class of security. However, it may not

be simple to adapt loan rating systems to investment rating systems, especially for community and regional banks with less sophisticated risk management and modeling capabilities.

With respect to the use of bank's internal loan rating systems, concerns may arise about the potential use of material nonpublic information in purchases of investment securities. To alleviate these concerns, a bank may need to replicate systems used on its lending (or private) side for its investment (or public) side in order to demonstrate a negative—i.e., that it did *not* make investments based on material nonpublic information. The use of third-party data and analysis, as discussed in our answer to Question 17, below, could mitigate these concerns but may not be attractive to banks with well developed, robust internal systems.

9. Should the creditworthiness standard include only high quality and highly liquid securities? Should the standard include specific standards on probability of default? Should the standard vary by asset class? Are there other alternative creditworthiness standards that should be considered?

The creditworthiness standard should include a wide range of securities, as the quality and liquidity of securities can change over time. A standardized approach could be based, at least in part, on the probability of default of particular asset classes.

10. If the OCC relied upon internal rating systems, should the creditworthiness standard include any pass grade or should it only be mapped to higher grades of pass?

The creditworthiness standard employed by internal rating systems should be allowed to vary by bank, subject to supervisory review. We do not think it is necessary to specify the level of granularity of internal ratings systems. Rather, internal systems should comport with the techniques used by the bank in managing its assets and, in any case, would be subject to supervisory review as to their appropriateness.

11. Alternatively, should the banking regulators revive the current regulatory risk rating system to include more granularity in the pass grade and develop a creditworthiness standard based upon the regulatory risk rating system?

A greater level of granularity in the pass grade could be helpful in designing a standardized approach. A well-designed granular approach to “pass” grades could enhance risk sensitivity consistent with safety and soundness.

12. Should the OCC adopt standards for marketability and liquidity separate from the creditworthiness standard? If so, how should this differ from the creditworthiness standard?

Please see answer to Question 2.b., above.

13. Should an alternative approach establish different levels of quality that, for example, govern the amount of securities that may be held?

Generally, yes. This is consistent with the current investment regulations that base the amount of investment permitted in a class of security on measures of credit quality. As a general

proposition, it is appropriate to allow relatively unfettered ability to invest in high quality assets with a proven track record and limit investments in lower quality or more speculative investments.

14. Should an alternative approach take into account the ability of a security issuer to repay under stressed economic or market environments? If so, how should stress scenarios be applied?

We believe it would be appropriate to consider within the range of alternatives an approach that takes into consideration a bank's stress tests of its loan and investment portfolios, particularly for advanced approaches that rely on banks' internal models.

15. Should an assessment of creditworthiness link directly to a bank's loan rating system (for example, consistent with the higher quality credit ratings)?

For debt investments, a direct linkage to a bank's loan rating system may be appropriate, as some debt investments can be considered an alternative to a direct loan. For other investments, it may be appropriate to use the bank's loan rating system as an input but not as the sole determinant of quality. Again, this relates to the question of what risks the investment securities regulations are designed to capture – only the credit risk of an investment, or market, liquidity, and other relevant risks as well.

16. Should a bank be permitted to consider credit assessments and other analytical data gathered from third parties that are independent of the seller or counterparty? What, if any, criteria or standards should the OCC impose on the use of such assessments and data?

Please see answer to Question 17, below.

17. Should a bank be permitted to rely on an investment quality or credit quality determination made by another financial institution or another third party that is independent of the seller or the counterparty? What, if any, criteria or standards should the OCC impose on the use of such opinions?

Yes, banks should be permitted to rely on the determinations of independent third parties in analyzing investment or credit quality. This is particularly critical for banks that may not have the capability in-house to conduct a robust review. Third party assessments would be subject to supervisory review, and banks would be expected to conduct due diligence on the bona fides of any third party provider prior to using it in their risk management processes.

18. Which alternative would be most appropriate for community banks and why?

As discussed in our answer to Question 6, above, a standardized approach could be based on the assignment of different classes of securities to investment limitations, much like the current approach but without the use of credit ratings. The assignment could be based on, among other possible factors, the historical performance of the class of security.

19. Are there other alternatives that ought to be considered?

Please see answer to Question 5, above.

20. What level of due diligence should be required when considering the purchase of an investment security? How should the OCC set minimum standards for monitoring the performance of an investment security over time so that banks effectively ensure that their investment securities remain “investment quality” as long as they are held?

The OCC requires banks to conduct an on-going analysis of the investment quality of their securities portfolios in order to validate or change, as appropriate, their assessments. As noted in our answer to Question 17, above, this analysis could be conducted in-house or outsourced to appropriate independent third parties.

Any minimum standards for monitoring the performance of investments should depend on the nature of the investment and be consistent with principles of proportionality.

21. Are there considerations, in addition to those discussed above, that the agency should address in developing alternative creditworthiness standards for regulations pertaining to securities issuances or international banking activities?

For international banking activities, consideration should be given to international competitiveness and level playing-field concerns, especially in light of the fact that foreign competitors of banks are expected to continue to rely on credit ratings in connection with the conduct of their banking activities.

22. What standard or standards should the OCC adopt to replace the investment grade requirement in section 16.6? Please comment on how the alternative standard will ensure that potential purchasers of nonconvertible debt have access to necessary information about the issuing bank and have the appropriate knowledge and experience to evaluate that information.

Please see answer to Question 21, above.

23. What standard or standards should the OCC adopt to specify the types of assets eligible for the CED under Part 28 (section 4(g) of the IBA)? To what extent are alternative standards consistent with the maintenance of sound financial condition, and the protection of depositors, creditors, and the public interest?

The key concern with respect to assets eligible for the CED is the credit quality of the issuer and the ability to keep the assets within the domestic banking system (i.e., in the United States) in the event of the failure of a foreign bank. It would be difficult for foreign banks to adopt alternatives to the use of internationally recognized credit ratings and, as there is no requirement under the Dodd-Frank Act to change these standards, we would recommend that they remain unchanged.

Conclusion

For the reasons stated above, ABA and ABASA believe that credit ratings should be considered to be one of several factors that can be used to assess the creditworthiness of an investment, security, or other asset. A complete abandonment of the use of credit ratings as an indicator of creditworthiness could have significant negative competitive and market impacts not outweighed by risk management benefits.

As always, ABA, ABASA and our members remain available to discuss these issues with OCC. In the meantime, if you have any questions on the foregoing, please contact the undersigned.

Sincerely,



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