

## BY ELECTRONIC MAIL

December 29, 2011

Office of the Comptroller of the Currency  
250 E Street, SW, Mail Stop 2-3  
Washington, DC 20219

Re: Alternatives to the Use of Credit Ratings in the Regulations of the OCC  
76 *Federal Register* 73526 (November 29, 2011), Docket OCC-2011-0019

Guidance on Due Diligence Requirements in Determining Whether Investment Securities  
Are Eligible for Investment, 76 *Federal Register* 73777 (November 29, 2011)  
Docket OCC-2011-0022

Dear Sir or Madam,

The American Bankers Association (ABA),<sup>1</sup> the ABA Securities Association (ABASA),<sup>2</sup> the Financial Services Roundtable,<sup>3</sup> and The Clearing House<sup>4</sup> (the Associations) appreciate the opportunity to respond to the requests for comment by the Office of the Comptroller of the Currency (OCC) on the proposal to eliminate references to credit ratings in its non-capital rules and on proposed guidance on eligible investment securities. These proposals implement Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)<sup>5</sup> which directs OCC to remove references to, or requirements of reliance on, credit ratings and to replace such ratings with an appropriate standard of creditworthiness.

The proposal would remove references to credit ratings provided by Nationally Recognized Statistical Rating Organizations (NRSROs) and replace those references with a newly established credit quality standard in OCC's existing regulations for national banks in 12 C.F.R. Part 1, Investment Securities, Part 16, Securities Offering Disclosure Rules and Part 28, International Banking Activities. In addition, the proposal would similarly replace references to credit ratings in Part 160, Lending and Investment for federally chartered savings institutions. The proposed guidance would clarify steps national banks and federal savings associations should take to demonstrate that they have properly verified that their investments meet the newly established credit quality standards.

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<sup>1</sup> 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. Learn more at [www.aba.com](http://www.aba.com).

<sup>2</sup> 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.

<sup>3</sup> The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for \$92.7 trillion in managed assets, \$1.2 trillion in revenue, and 2.3 million jobs.

<sup>4</sup> Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at [www.theclearinghouse.org](http://www.theclearinghouse.org).

<sup>5</sup> *Pub. L.* 111-203, Section 939A, 125 Stat. 1376, 1887 (July 21, 2010).

The Associations appreciate the efforts of OCC to implement Section 939A, a problematic provision, with the least possible amount of complexity and burden on the industry, particularly smaller institutions. While we generally support the proposal, we remain concerned that the compliance burdens on all institutions, especially small financial institutions, will significantly limit their options for available investments both to their detriment and that of their local communities.

## **BACKGROUND**

As discussed below, OCC's current rules governing permissible investment securities and registration of bank-issued securities incorporate references to credit ratings when determining whether particular securities are "investment grade."

### **1. Investment Securities**

OCC's investment securities regulations at 12 C.F.R. Part 1 and at 12 C.F.R. Part 160 prescribe standards under which banks and federal savings associations may purchase, sell, deal in, underwrite, and hold securities consistent with safe and sound banking practices. Investment securities are defined in Part 1 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. 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. Credit ratings also are used to determine marketability in the case of a security that is offered and sold under the Securities and Exchange Commission's (SEC) Rule 144A.<sup>6</sup>

OCC's rules delineate five different types of permissible types of securities in which institutions may invest. Type I securities are generally obligations of the United States or the several government-sponsored agencies, general obligations of states and local governments, and other municipal bonds if the institution is well capitalized. The remaining permissible categories of investments require that the securities be "investment grade," certain of which incorporate concentration limits.

OCC's rules at Part 160 regarding investments by federal savings associations reference NRSRO ratings with respect to corporate debt securities, commercial paper and municipal revenue bonds. Pursuant to the Dodd-Frank Act, the Federal Deposit Insurance Corporation (FDIC) will establish requirements for the purchase of these securities by all insured savings associations. The FDIC has currently released a proposed rule and proposed guidance to implement this statutory requirement, and the Associations will comment separately on these proposals.

### **2. Required Due Diligence**

OCC's current rules at 12 C.F.R. 1.5 require national banks, as a safe and sound banking practice, to make a determination as to an issuer's ability to make all required payments on its obligations and to consider the various risks posed by the security. These include interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic and reputations risks, as well as whether the investment is appropriate for the particular institution. The proposal does not amend Section 1.5. Similar standards apply to federal savings and loan associations.

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<sup>6</sup> Under part 1, a 144A security is deemed to be marketable if it is rated investment grade or the credit equivalent of investment grade.

## **DISCUSSION**

Our members are very concerned about the unintended consequences of the proposal. Because of the expanded scope of due diligence requirements under the proposal, more of every institution's resources will be required to assess and periodically monitor any given investment security. Thus, institutions of all sizes will, of necessity, be constrained in the numbers of securities they can consider for their portfolios. As a result, it is highly likely that concentration issues will become more prevalent as institutions commit their limited resources to securities requiring less due diligence or for which due diligence has already been conducted. In addition, our members are concerned that institutions will be subject to after-the-fact criticism by examiners despite having conducted reasonable due diligence with respect to the institution's investments.

### **1. New Definition of "Investment Grade"**

Under the proposal, in Parts 1, 16 and Section 160.42 references to "investment grade" ratings would be replaced with a new standard: a security would be rated "investment grade" if the issuer of the security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. The proposal further specifies that an issuer has an adequate capacity to meet financial requirements if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected. Given the statutory constraints of Section 939A, the Associations generally support this newly formulated definition of "investment grade."

### **2. Due Diligence Requirement**

Institutions would be required to perform due diligence sufficient to demonstrate that an investment security meets the above standard. Both the proposal and the proposed guidance emphasize that the scope of the required due diligence should be a function of the security's credit quality, the complexity of the structure, and the size of the investment as well as the institution's risk profile. Thus, the proposal states that the more complex a security's structure is, the more credit-related due diligence an institution should perform, even when the credit quality is perceived to be very high.<sup>7</sup>

OCC expects national banks and federal savings associations to consider a variety of factors relevant to the particular security when determining whether a security is a permissible investment, such as consideration of internal analyses, third-party research and analytics including external credit ratings, internal risk ratings, default statistics, and other sources of information as appropriate for the particular security. Importantly, under the proposal external ratings, including ratings by NRSROs, could continue to be a factor in an institution's assessment of an issuer's financial capacity when supplemented with appropriate due diligence processes and analyses.

As discussed more fully below, we continue to have concerns about the burden of the due diligence on all institutions, but, in particular, on smaller institutions.

### **3. Scope of Required Due Diligence**

The proposed guidance sets forth a non-exclusive checklist of possible factors for determining whether a particular security satisfies the new "investment grade" standard for four categories of securities: corporate bonds, municipal general obligations, municipal revenue bonds, and structured products.

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<sup>7</sup> The proposal provides that bank management should ensure they understand the security's structure and how the security will perform in different default environments, and should be particularly diligent when purchasing structured securities.

**a. U.S. Government Securities**

We note that the proposed guidance states that “[a]lthough Part 1 has no specified quality requirements for type I securities, as a matter of prudent banking practice, national banks should conduct an appropriate level of due diligence prior to purchasing a material amount (to the institution) of these type I securities.”<sup>8</sup> Type I securities are obligations of the United States or the several government-sponsored agencies, general obligations of states and local governments, and other municipal bonds if the investing institution is well capitalized. Although the categories for which OCC has provided the checklist do not include U.S. government securities, we nonetheless believe the above statement could be read to require due diligence on such instruments. The Associations believe strongly that institutions should not be required to perform due diligence on U.S. government securities which, as a practical matter, present no unknown credit or other risk to their holders. Accordingly, we urge OCC to clarify in the final guidance that such due diligence is not required.

**b. Differentiations Based on Institutions’ Size and Complexity**

OCC has asked whether the guidance should provide differentiations based on the size and scope of the institution with respect to consideration of the factors relevant to whether an institution has satisfied its due diligence requirements or whether a particular security has good credit quality. The Associations believe such differentiation is absolutely critical for institutions to be able to manage their investment portfolios while avoiding undue concentrations. Our members are very concerned that without greater differentiation between institutions based on their size and/or complexity, the judgments made by examiners will be highly subjective leading to much “second guessing” of institutions’ reasonable investment decisions. In addition, we also believe that a lack of reasonable differentiation will result in fewer permissible securities in which small institutions, in particular, may be willing to invest, leading, in turn, to potential concentration concerns.

We believe there is a huge difference in the capacity of smaller institutions versus larger institutions to develop sophisticated risk systems or to pay third parties to conduct due diligence for them. This is especially the case for purchases of small amounts of investment securities or purchases that are very small relative to an institution’s capital. For example, if a small bank purchases an \$80,000 municipal bond, it is not cost effective to hire an outside party to conduct ongoing due diligence.

Further, we are aware of smaller institutions that have significant diversified holdings in numerous individual municipal bonds that are among the highest yielding instruments in their portfolios. Because the investments are spread out among a large number of municipal bonds, each of which will require increased individualized due diligence, it is likely that institutions will reduce such investments because of cost considerations, thereby leading to increased concentrations in their portfolios and lower overall investment income.

As a result of the constraints caused by the proposed due diligence requirements, we believe there are likely to be unintended consequences for local issuers, particularly for small municipalities. In smaller communities, municipal bonds may be unrated and issued in small denominations (often less than \$1 million). If banks are uncertain about the due diligence required to establish that such bonds meet the “investment grade” standard, this may well have negative “trickle-down” consequences for local communities. For example, in Missouri, many school districts issue Lease Certificates of Participation. These are usually very small issues and a very cost-effective instrument for issuing debt in small districts. They are considered to be municipal revenue bonds and are seldom rated. Although some of our members have purchased such instruments on a regular basis, they will likely discontinue doing so due to the increased scrutiny these bonds may attract because they are not general obligation bonds.

Accordingly, we urge OCC to further abbreviate its proposed checklists for smaller institutions. We note that the *1998 Interagency Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities* states that “[n]ot all investment instruments may need to be subjected to a pre-

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<sup>8</sup> 76 Fed. Reg. 73777 at 73779.

purchase analysis. Relatively simple or standardized instruments, the risks of which are well known to the institution, would likely require no or significantly less analysis than would more volatile, complex instruments.”<sup>9</sup> For example, OCC could specify that less due diligence is necessary for an investment that is a minimal percent of capital. We would be happy to discuss further with OCC staff ways to further differentiate their due diligence guidelines based on the size or other characteristics of smaller institutions.

#### **4. Transition Period**

The Associations strongly urge OCC to provide a reasonable transition period for compliance with the due diligence requirements. This is necessary, we believe, because institutions’ due diligence processes will be under far greater scrutiny by examiners as a result of the new definition of “investment grade” than was previously the case. Institutions of all sizes will likely be required to establish or upgrade in-house systems, analytical capabilities and/or management capabilities. As a result, we recommend that any final rule provide a transition period of one year before compliance is required to make the necessary systems changes. Finally, we urge OCC in the final rule to provide that existing portfolios will be grandfathered, or absent grandfathering, that institutions be given an additional year beyond the transition period to review existing securities portfolios.

#### **CONCLUSION**

In conclusion, the Associations generally support OCC’s proposed rule and proposed guidance with the modifications discussed above. We believe significant differentiation based on institutions’ size and/or complexity will be necessary for the proposals to be workable. In addition, we believe the transition period described above is necessary to allow institutions to adjust their due diligence processes to conform to the proposals going forward.

If you have any questions about the foregoing, please do not hesitate to contact the undersigned.

Sincerely,



Cristeena G. Naser  
Senior Counsel, American Bankers Association  
Associate General Counsel, ABA Securities  
Association



Eli Peterson  
Senior Regulatory Counsel & Associate General  
Counsel  
The Clearing House Association L.L.C.



Richard Whiting  
Executive Director and General Counsel  
The Financial Services Roundtable

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<sup>9</sup> 63 Fed. Reg. 20191 at 20196.