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BY ELECTRONIC MAIL

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, D.C. 20552

Re: Advance Notice of Proposed Rulemaking on Alternatives to the Use of External Credit Ratings in the Regulations of the OTS, 75 *Federal Register* 63107, October 14, 2010

Docket No. OTS-2010-0029; RIN 1557-AC44

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 Thrift Supervision (OTS) pursuant to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] (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. OTS has identified references to credit ratings in its regulations at 12 CFR Part 560 on investment securities. Regulations related to risk-based capital are the subject of a separate ANPR. Many ABA members are savings associations that are subject to these OTS regulations.

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 DFA and changes in industry practice render unnecessary the abandonment of the use of credit ratings as an indicator of creditworthiness. These changes include the following:

- 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.

[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).

- 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 some 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 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.[4] These developments should allow for continued regulatory reliance on credit ratings.

If the OTS 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

OTS's investment securities regulations at 12 CFR Part 560 prescribe standards under which savings associations may purchase 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 a nationally recognized statistical rating organization (NRSRO). The OTS uses NRSRO ratings as a factor for the permissibility of investments as well as appropriate concentration levels of different classes of investment securities that a savings association may purchase and hold. Credit ratings are also used to determine marketability of securities offered and sold pursuant to Securities and Exchange Commission (SEC) Rule 144A. A 144A security generally is deemed marketable if it is rated investment grade.

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

- *Credit quality-based standard.* OTS 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 "pass" asset under the bank's internal credit rating standards. OTS could require the bank to document that the issuer:

[4] See, e.g., www.standardandpoors.com/about-sp/leadership-actions.

- 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. OTS 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.* OTS 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.

- *Reliance on internal risk ratings.* OTS could adopt a creditworthiness standard based on the savings association's internal risk rating systems similar to the process used for loan classifications, subject to documentation and review.

- *Reliance on External Information*. OTS could allow savings associations to consider external data, including credit analyses provided by third parties, that met standards established by OTS. Alternative methods to measure credit risk could be derived from market prices of traded instruments.

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, savings associations will be at risk of being criticized by examiners after the fact when their judgments about the same security differ.

Savings associations 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 investments when savings associations are unable to participate, for example, in a local project, because they cannot perform the necessary credit assessments.

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 Part 560). 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 OTS's regulations with the intended use and purposes of such ratings as expressed by the rating agencies. Standard & Poor's notes on its website[5] 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 have declined to adopt criteria to address directly market liquidity. The OTS 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 OTS permit savings associations 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.

2b. What alternative measures could the OTS and savings associations 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. provide for a reasonable and objective assessment of the likelihood of full repayment of principal and interest over the life of the security;

[5] www.standardandpoors.com/about-sp/leadership-actions.

b. foster prudent risk management;
c. be transparent, replicable, and well defined;
d. allow different savings associations to assign the same assessment of credit quality to the same or similar credit exposures;
e. allow for supervisory review;
f. differentiate among investments in the same asset class with different credit risk; and
g. 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 that can satisfy these criteria could include historical performance and market data, which can be incorporated into a standardized approach or into savings associations' internal credit risk assessment models.

> 5. OTS 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 OTS to consider a range of options for savings associations to use in measuring creditworthiness, with a savings association 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 but without the use of credit ratings. The assignment could be based on the historical performance of the class of security or average credit spreads. An advanced approach based on internal models could be made available for savings associations 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 associations to strike the appropriate balance between precision of measurement and implementation burden. Some savings associations 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. Others may favor an approach that is more precise and reflects more accurately the particular holdings in the association's portfolio. Savings associations will have different reasons for adopting different approaches: the importance of the investment portfolio to 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 OTS should take into account? What additional burden, especially at community and regional savings associations, might arise from the implementation of alternative methods of measuring creditworthiness?

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 savings association 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 savings associations, particularly community and regional associations, will need to outsource the development of new systems, adding to cost burdens. A cost-effective, simple standardized approach is particularly important for these associations 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 OTS and other federal banking agencies for regulatory capital purposes. OTS 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 risk bucketing approach might be appropriate for banks and savings associations that do not or cannot elect an internal models-based approach. This standardized approach could be adapted for both sets of regulations, allowing banks and savings associations to use a broadly similar methodology for investment allocation and capital adequacy purposes. Banks and savings associations 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*?

<u>Credit Quality-Based Standard</u>. A credit quality-based standard would require savings association 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." Savings associations 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 association and the complexity of its investment activities. A credit quality-based standard would continue existing risk management requirements and should not create undue burden or cost to savings associations. This approach could be the basis for a standardized approach to assessing the creditworthiness of investment securities under 12 CFR Part 560.

<u>Investment Quality-Based Standard</u>. 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 savings association 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 savings associations 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.

<u>Reliance on Internal Risk Ratings</u>. This approach would rely on a savings association's internal risk rating systems using systems and criteria similar to the association's internal loan rating system. This approach has the advantage of using existing systems as the basis for analyzing whether and to what extent a savings association 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 smaller and less complex associations with limited risk management capabilities.

<u>Reliance on External Information</u>. Savings associations should be permitted to rely on the determinations of independent third parties in analyzing investment or credit quality. This is particularly critical for smaller, less complex associations that may not have the capability in-house to conduct a robust review. Third party assessments would be subject to supervisory review and associations would be expected to conduct due diligence on the bona fides of any third party provider prior to using them in their risk management processes.

> 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? Should a combination of creditworthiness standards be used and, if so, in what instances would this be preferred? Would different creditworthiness standards be appropriate for different asset classes, probabilities of default, varying levels of liquidity, different types of securities or money market instruments, etc?

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. The use of a combination of creditworthiness standards needs to balance the potential for improved accuracy with increased burden on savings associations.

> 10. If the OTS 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 savings association, 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 savings association 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 OTS 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 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 savings association's stress tests of its loan and investment portfolios, particularly for advanced approaches that rely on internal models.

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

For debt investments, a direct linkage to a savings association'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 association'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.

15. Should a savings association 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 OTS impose on the use of such assessments and data?

Please see answer to Question 16, below.

16. Should a savings association 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 OTS impose on the use of such opinions?

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

> 17. Which alternative(s) would be most appropriate for smaller, community-oriented savings associations 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.

> 18. Are there other alternatives that ought to be considered?

Please see answer to Question 5, above.

> 19. What level of due diligence of a savings association should be required when considering the purchase of an investment security? How should OTS set minimum standards for monitoring the performance of an investment security over time so that savings associations effectively ensure that their investment securities remain "investment quality" as long as they are held?

The OTS requires savings associations 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 16, 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.

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 OTS. In the meantime, if you have any questions on the foregoing, please contact the undersigned.

Sincerely,

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