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**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the Currency**

**12 CFR Parts 1, 16 and 28**

**Docket ID: OCC-2010-0017**

**RIN 1557-AD36**

**Alternatives to the Use of External Credit Ratings in the Regulations of the OCC**

**AGENCIES:** Office of the Comptroller of the Currency (OCC).

**ACTION:** Advance notice of proposed rulemaking.

**SUMMARY:** Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) directs all Federal agencies to review, no later than one year after enactment, any regulation that requires the use of an assessment of credit-worthiness of a security or money market instrument and any references to or requirements in regulations regarding credit ratings. The agencies are also required to remove references or requirements of reliance on credit ratings and to substitute an alternative standard of credit-worthiness.

Through this ANPR, the OCC seeks comment on the implementation of section 939A with respect to its regulations (other than risk-based capital regulations, which are the subject of a separate ANPR issued jointly with the other Federal banking agencies),

including alternative measures of credit-worthiness that may be used in lieu of credit ratings.

**DATES:** Comments on this ANPR must be received by [INSERT DATE 60 DAYS AFTER FEDERAL REGISTER PUBLICATION].

**ADDRESS:** Comments should be directed to:

**OCC:** Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or e-mail, if possible. Please use the title “Alternatives to the Use of External Credit Ratings in the Regulations of the OCC” to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- **Federal eRulemaking Portal—“regulations.gov”:** Go to <http://www.regulations.gov>. Select “Document Type” of “Proposed Rules,” and in “Enter Keyword or ID Box,” enter Docket ID “OCC-2010-0017,” and click “Search.” On “View By Relevance” tab at bottom of screen, in the “Agency” column, locate the advance notice of proposed rulemaking for OCC, in the “Action” column, click on “Submit a Comment” or “Open Docket Folder” to submit or view public comments and to view supporting and related materials for this rulemaking action.
- Click on the “Help” tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or viewing public

comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.

- **E-mail:** regs.comments@occ.treas.gov.
- **Mail:** Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.
- **Fax:** (202) 874-5274.
- **Hand Delivery/Courier:** 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.

*Instructions:* You must include “OCC” as the agency name and “Docket ID OCC-2010-0017” in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this advance notice of proposed rulemaking by any of the following methods:

- **Viewing Comments Electronically:** Go to <http://www.regulations.gov>. Select “Document Type” of “Public Submissions,” in “Enter Keyword or ID Box,” enter Docket ID “OCC-2010-0017,” and click “Search.” Comments will be listed under “View By Relevance” tab at bottom of screen. If comments from more than one

agency are listed, the “Agency” column will indicate which comments were received by the OCC.

- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments.
- **Docket:** You may also view or request available background documents and project summaries using the methods described above.

**FOR FURTHER INFORMATION CONTACT:**

OCC: Michael Drennan, Senior Advisor, Credit and Market Risk Division, (202) 874-5670; or Carl Kaminski, Senior Attorney, Legislative and Regulatory Activities Division, (202) 874-5090; or Beth Kirby, Special Counsel, Securities and Corporate Practices Division, (202) 874-5210, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

**SUPPLEMENTARY INFORMATION:**

**I. BACKGROUND**

Section 939A of the Act requires each Federal agency to review (1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and (2) any references to or

requirements in such regulations regarding credit ratings.<sup>1</sup> Each Federal agency must then modify any such regulations identified by the review ... to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations. In developing substitute standards of credit-worthiness, an agency shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by the agency, taking into account the entities it regulates that would be subject to such standards.<sup>2</sup>

This ANPR describes the areas where the OCC's regulations, other than those that establish regulatory capital requirements, currently rely on credit ratings; sets forth the considerations underlying such reliance; and requests comment on potential alternatives to the use of credit ratings. The OCC and the other Federal banking agencies are issuing a separate joint advance notice of proposed rulemaking focused on the agencies' risk-based capital frameworks.

## **II. OCC REGULATIONS REFERENCING CREDIT RATINGS**

The non-capital regulations of the OCC include various references to and requirements for use of a credit rating issued by a nationally recognized statistical rating organization (NRSRO).<sup>3</sup> For example, the OCC's regulations regarding permissible investment securities, securities offerings, and international activities each reference or rely upon NRSRO credit ratings.<sup>4</sup> A description of these regulations is set forth below.

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<sup>1</sup> Pub. L. 111-203, 124 Stat. 1376, section 939A (July 21, 2010).

<sup>2</sup> Id.

<sup>3</sup> An NRSRO is an entity registered with the U.S. Securities and Exchange Commission (SEC) under section 15E of the Securities Exchange Act of 1934. See, 15 U.S.C. 78o-7, as implemented by 17 CFR 240.17g-1.

<sup>4</sup> See generally, 12 CFR part 1 (investment securities), 12 CFR part 16 (securities offerings), and 12 CFR part 28 (international banking activities).

## **A. Investment Securities Regulations**

The OCC's investment securities regulations at 12 CFR part 1 use credit ratings as a factor for determining the credit quality, liquidity/marketability, and appropriate concentration levels of investment securities purchased and held by national banks. For example, under these rules, an investment security must not be "predominantly speculative in nature."<sup>5</sup> The OCC rules provide that an obligation is not "predominantly speculative in nature" if it is rated investment grade or, if unrated, is the credit equivalent of investment grade. "Investment grade," in turn, is defined as a security rated in one of the four highest rating categories by two or more NRSROs (or one NRSRO if the security has been rated by only one NRSRO).<sup>6</sup>

Credit ratings are also used to determine marketability in the case of a security that is offered and sold pursuant to Securities and Exchange Commission Rule 144A. Under Part 1, a 144A security is deemed to be marketable if it is rated investment grade or the credit equivalent of investment grade.

In addition, credit ratings are used to determine concentration limits on certain investment securities. For example, Part 1 limits holdings of Type IV small business related securities of any one issuer that are rated in the third or fourth highest investment grade rating categories to 25 percent of the bank's capital and surplus.<sup>7</sup> However, there is no concentration limit for small business-related securities that are rated in the highest or second highest investment grade categories.<sup>8</sup>

### Current Safety and Soundness Standards

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<sup>5</sup> See, 12 CFR 1.5(e).

<sup>6</sup> 12 CFR 1.2(d).

<sup>7</sup> A Type IV investment security includes certain small business related securities, commercial mortgage related securities, or residential mortgage related securities. See, 12 CFR 1.2(m).

<sup>8</sup> See, 12 CFR 1.3(e), 1.2(m).

In addition to current regulatory provisions that generally limit banks to purchasing securities that are rated investment grade or, if not rated, are the credit equivalent of investment grade, OCC regulations also require that banks make the investments consistent with safe and sound banking practices.<sup>9</sup> Specifically, banks must consider the interest rate, credit, liquidity, price and other risks presented by investments and the investment must be appropriate for the particular bank.<sup>10</sup> Whether a security is an appropriate investment for a particular bank will depend upon a variety of factors, including the bank's capital level, the security's impact on the aggregate risk of the portfolio, and management's ability to measure and manage bank-wide risks. In addition, a bank must determine that there is adequate evidence that the obligor possesses resources sufficient to provide for all required payments on its obligations.<sup>11</sup> Each bank also must maintain records available for examination purposes adequate to demonstrate that it meets the above requirements.<sup>12</sup>

The OCC has issued guidance on safe and sound investment securities practices. The OCC expects banks to understand the price sensitivity of securities before purchase (pre-purchase analysis) and on an ongoing basis.<sup>13</sup> Appropriate ongoing due diligence includes the ability to assess and manage the market, credit, liquidity, legal, operational and other risks of investment securities. As a matter of sound practice, banks are expected to perform quantitative tests to ensure that they thoroughly understand the accompanying cash flow and interest rate risks of their investment securities.

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<sup>9</sup> 12 CFR 1.5.

<sup>10</sup> 12 CFR 1.5(a).

<sup>11</sup> 12 CFR 1.5(b).

<sup>12</sup> 12 CFR 1.5(c).

<sup>13</sup> OCC Bulletin 98-20, "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities."

Sound investment practices dictate additional due diligence for purchases of certain structured or complex investment securities. The more complex a security's structure, the more due diligence that bank management should conduct. For securities with long maturities or complex options management should understand the structure and price sensitivity of its securities purchased. For complex asset-backed securities, such as collateralized debt obligations, bank management should ensure that they understand the security's structure and how the security will perform in different default environments.<sup>14</sup>

### Alternative Standards

Three options for replacing the references to external credit ratings in the OCC's investment securities regulations include the following.

1. Credit Quality Based Standard

One alternative would be to replace the references to credit ratings with a standard that is focused primarily on credit quality. The OCC could adopt standards similar to those applied to unrated securities. Specifically, banks could be required to document, through their own credit assessment and analysis, that the security meets specified internal credit rating standards.

Part 1 permits the purchase of investment securities that are not predominately speculative in nature. Under the current rules, a security is not predominately speculative in nature if it is rated investment grade or, if unrated, is the credit-equivalent of investment grade. To show that a non-rated security is the credit equivalent of investment grade, a bank must document, through its own credit assessment and analysis, that the security is a strong "pass" asset under its internal credit rating standards.

(Because most internal bank rating systems "pass" some credit exposures that are not, or

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<sup>14</sup> OCC Bulletin 2002-19, "Unsafe and Unsound Investment Portfolio Practices."

would not be, rated investment grade, a security will generally have to be rated higher than the bottom tier of internal credit rating "pass" standards in order to be the credit equivalent of investment grade.) Moreover, as a prudent credit practice, the OCC currently expects banks to review the quality of material holdings of non-rated securities on an ongoing basis after purchase. Banks that fail to perform and document the necessary credit analysis are not in compliance with 12 CFR part 1 and the sound investment practices outlined in OCC Bulletin 98-20, "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities."

If the OCC adopts a general credit-quality based test that does not rely on external credit ratings, the OCC could require banks to determine that their investment securities meet certain credit quality standards. Banks could be required to document an internal credit assessment and analysis demonstrating that the issuer of a security is an entity that has an adequate capacity to meet its financial commitments, is subject only to moderate credit risk, and for whom expectations of default risk are currently low. As is currently the case for non-rated securities,<sup>15</sup> the OCC would require banks to document their credit assessment and analysis using systems and criteria similar to the bank's internal loan credit grading system. These reviews would be subject to examiner review and classification, similar to the process used for loan classifications.

If this alternative were adopted, national banks would continue to be expected to understand and manage the associated price, liquidity and other-related risks associated with their investment securities activities.

## 2. Investment Quality Based Standard

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<sup>15</sup> See, 12 CFR 1.5(c).

As an alternative to a standard that focuses solely on credit-worthiness, the OCC could adopt a broader “investment quality” standard that, in addition to credit worthiness elements (such as the timely repayment of principal and interest and the probability of default), such a standard also would establish criteria for marketability, liquidity and price risk associated with market volatility.

As previously noted, the OCC’s current investment securities regulations and guidance emphasize that national banks must consider, as appropriate, credit, liquidity, and market risk, as well as any other risks presented by proposed securities activities. An investment quality based standard could reflect some combination of these considerations and place quantitative limits on banks’ investment securities activities based on the levels and types of risks in its portfolio. As with the credit quality standard, the OCC could require banks to document their credit assessment and analysis using systems and criteria similar to the bank’s internal loan credit grading system. Such reviews would be subject to examiner review and classification, similar to the process used for loan classifications.

Under such a standard, a security with a low probability of default may nevertheless be deemed “predominantly speculative in nature,” and therefore impermissible, if, under the new standard, it is deemed to be subject to significant liquidity or market risk. This would be consistent with current OCC guidance, which warns that complex and illiquid instruments often can involve greater risk than actively traded, more liquid securities. Oftentimes, this higher potential risk arising from illiquidity is not captured by standardized financial modeling techniques. Such risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as

expected, the demand for such instruments can evaporate, decreasing the market value of the instrument below the modeled value.

3. Reliance on internal risk ratings

A third alternative could establish a credit worthiness standard that is based on a bank's internal risk rating systems. The OCC could require a bank to document its credit assessment and analysis using systems and criteria similar to its internal loan credit rating system. Such reviews also would be subject to examiner review and classification, similar to the process used for loan classifications.

The bank regulatory agencies use a common risk rating scale to identify problem credits. The regulatory definitions are used for all credit relationships — commercial, retail, and those that arise outside lending areas, such as from capital markets. The regulatory ratings “special mention,” “substandard,” “doubtful,” and “loss” identify different degrees of credit weakness. Therefore, for example, the rule could define all investments deemed “special mention” or worse as predominately speculative. Credits that are not covered by these definitions would be “pass” credits, for which no formal regulatory definition exists (because regulatory ratings currently do not distinguish among pass credits). Many banks have internal rating systems that distinguish between levels of credit-worthiness in the regulatory “pass” grade. In these systems, “pass” grades that denote lower levels of credit-worthiness usually do not equate to investment grade as defined in the current rule.

This option would be similar to the OCC's current treatment of unrated securities. Part 1 permits the purchase of investment securities that are not predominately speculative in nature. Under the current rules, a security is not predominately speculative

in nature if it is rated investment grade, or if unrated, is the credit-equivalent of investment grade. National banks must document, through its own credit assessment and analysis, that the security is a strong "pass" asset under its internal credit rating standards to demonstrate that a non-rated security is the credit equivalent of investment grade. Because most internal bank rating systems "pass" some credit exposures that are not, or would not be, rated investment grade, a security will generally have to be rated higher than the bottom tier of internal credit rating "pass" standards in order to be the credit equivalent of investment grade.

## **B. Securities Offerings**

Securities issued by national banks are not covered by the registration provisions and SEC regulations governing other issuers' securities under the Securities Act of 1933. However, the OCC has adopted part 16 to require disclosures related to national bank-issued securities. Part 16 includes references to "investment grade" ratings. For example, section 16.6, which provides an optional abbreviated registration system for debt securities that meet certain criteria, requires that a security receive an investment grade rating in order to qualify for the abbreviated registration system.<sup>16</sup> The OCC designed the requirements of the abbreviated registration 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.

Part 16 also cross-references to SEC regulations governing the offering of securities under the Securities Act of 1933 that may include references to or reliance on

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<sup>16</sup> In addition, section 16.2(g) defines the term "investment grade" as a security that is rated in one of the top four ratings categories by each NRSRO that has rated the security.

NRSRO credit ratings. The SEC is preparing to undertake a similar review of its regulations in accordance with the Dodd-Frank Act.<sup>17</sup> The OCC will consider any proposed and final changes to SEC regulations that are cross-referenced in part 16 in deciding whether to amend the references to the SEC’s regulations in part 16, and whether the application of the SEC’s regulations continues to be appropriate under part 16 in order to provide comparable investor protections covering bank-issued securities.

### **C. International Banking Activities**

Pursuant to section 4(g) of the International Banking Act (IBA),<sup>18</sup> foreign banks with Federal branches or agencies must establish and maintain a capital equivalency deposit (CED) with a member bank located in the state where the Federal branch or agency is located. The IBA authorizes the OCC to prescribe regulations describing the types and amounts of assets that qualify for inclusion in the CED, “as necessary or desirable for the maintenance of a sound financial condition, the protection of depositors, creditors, and the public interest.”<sup>19</sup> At 12 CFR 28.15, OCC regulations set forth the types of assets eligible for inclusion in a CED. Among these assets are certificates of deposit, payable in the United States, and banker's acceptances, provided that, in either case, the issuer or the instrument is rated investment grade by an internationally recognized rating organization, and neither the issuer nor the instrument is rated lower than investment grade by any such rating organization that has rated the issuer or the instrument.<sup>20</sup>

## **III. REQUEST FOR COMMENT**

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<sup>17</sup> See, <http://www.sec.gov/spotlight/regreformcomments.shtml>.

<sup>18</sup> 12 U.S.C. § 3102(g).

<sup>19</sup> 12 U.S.C. § 3102(g)(4).

<sup>20</sup> See, 12 CFR 28.15(a).

The OCC is seeking public input as it begins reviewing its regulations pursuant to section 939A of the Dodd-Frank Act. In particular, the OCC is seeking comment on alternative measures of credit-worthiness that may be used instead of credit ratings in the regulations described in this ANPR. Commenters are encouraged to address the specific questions set forth below; the OCC also invites comment on any and all aspects of this ANPR.

### **General Questions**

1. In some cases the regulations described in this ANPR use credit ratings for purposes other than measuring credit-worthiness (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?

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 credit-worthiness would be prescribed?

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

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

4. In evaluating potential standards of credit-worthiness, 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;
- 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 credit-worthiness that can satisfy these criteria?

5. The OCC recognizes that any measure of credit-worthiness likely will involve tradeoffs between more refined differentiation of credit-worthiness 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 credit-worthiness?

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 credit-worthiness?

7. The credit rating alternatives discussed in this ANPR differ, in certain respects, to those being proposed by the OCC and 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?

**Alternatives for Replacing References to Credit Ratings in Part 1**

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

9. Should the credit-worthiness 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 credit-worthiness standards that should be considered?

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

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

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

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

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?

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

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?

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 counterparty? What, if any, criteria or standards should the OCC impose on the use of such opinions?

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

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

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?

**Alternatives Credit-worthiness Standards for Credit Ratings in Regulations Pertaining to Securities Issuances and International Banking Activities (parts 16 and 28)**

As discussed above, the OCC's regulations include a number of other references to credit ratings, including in regulations pertaining to securities issuances<sup>21</sup> and international banking activities.<sup>22</sup>

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

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

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<sup>21</sup> Certain limitations in Part 16 refer to a security that is "investment grade," which means that it is rated in one of the top four rating categories by each NSRSO that has rated the security. See, e.g. 12 CFR 16.2(g), and 12 CFR 16.6(a)(4).

<sup>22</sup> A foreign bank's capital equivalency deposits may consist of certificates of deposit, payable in the United States, and banker's acceptances, provided that, in either case, the issuer or the instrument is rated investment grade by an internationally recognized rating organization, and neither the issuer nor the instrument is rated lower than investment grade by any such rating organization that has rated the issuer or the instrument. 12 CFR 28.15.

[THIS SIGNATURE PAGE RELATES TO THE ADVANCE NOTICE OF PROPOSED  
RULEMAKING TITLED “ALTERNATIVES TO THE USE OF EXTERNAL CREDIT  
RATINGS IN THE REGULATIONS OF THE OCC”]

Date: August 9, 2010

By the Office of Comptroller of the Currency.

//SIGNED//

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John C. Dugan,

Comptroller of the Currency