



Comptroller of the Currency
Administrator of National Banks
US Department of the Treasury

RESCINDED

OCC 2010-32

Subject: Alternatives to the Use of Credit Ratings in OCC Regulations
Date: August 25, 2010

To: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel

Description: Advance Notices of Proposed Rulemaking

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security or money market instrument and (2) contain references to or requirements regarding credit ratings. In addition, the agencies are required to remove such references and requirements and replace them with substitute standards of credit-worthiness. In developing substitute standards of credit-worthiness, each agency is required to take into account the entities it regulates and, to the extent feasible, seek to establish uniform standards.

Use of Credit Ratings in Regulatory Capital Standards

The federal banking agencies (the OCC, Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) currently use credit ratings issued by nationally recognized statistical rating organizations (NRSROs) in their risk-based capital standards. These standards reference credit ratings in four general areas: (1) the assignment of risk weights to securitization exposures under the general risk-based capital rules and advanced approaches rules; (2) the assignment of risk weights to claims on, or guaranteed by, qualifying securities firms under the general risk-based capital rules; (3) the assignment of certain standardized specific risk add-ons under the agencies' market risk rule; and (4) the determination of eligibility of certain guarantors and collateral for purposes of the credit risk mitigation framework under the advanced approaches rules. In 2008, the agencies issued a notice of proposed rulemaking that sought comment on implementation in the United States of certain aspects of the standardized approach in the Basel Accord. The Basel standardized approach for credit risk relies extensively on credit ratings to assign risk weights to various exposures.

The agencies have issued a joint advance notice of proposed rulemaking (ANPR) to solicit comment and information as they begin to develop alternatives to the use of credit ratings in their capital rules (Capital ANPR). The Capital ANPR solicits input on alternative standards of credit-worthiness that could be used in lieu of credit ratings in those rules and asks for comments on a range of potential approaches, including basing capital requirements on more granular supervisory risk weights or on market-based metrics. The comment period for the Capital ANPR closes on October 25.

Use of Credit Ratings in Other OCC Regulations

The noncapital regulations of the OCC include various references to and requirements for use of credit ratings. These references include:

- *Investment Securities*—The OCC's investment securities regulations at 12 CFR 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." The OCC rule provides 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). 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. In addition, credit ratings are used to determine concentration limits on certain investment securities.

- *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.
- *International Banking Activities*—Pursuant to section (g) of the International Banking Act (IBA), 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." 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.

The OCC has issued an ANPR soliciting comment on alternative measures of credit-worthiness that may be used instead of credit ratings in the above regulations (Investment Securities and Other Regulations ANPR). The ANPR seeks comments on criteria that the OCC should consider when developing such measures and outlines a range of alternatives for replacing references to credit ratings in part 1. The comment period for the Investments and Other Regulations ANPR closes on October 12.

Further Information

For information or questions on the Capital ANPR, contact Mark Ginsberg, Risk Expert, Capital Policy Division, (202) 874-5070, or Carl Kaminski, Senior Attorney, Legislative and Regulatory Activities Division, (202) 874-5090. For information or questions on the Investment Securities and Other Regulations ANPR, contact Michael Drennan, Senior Advisor, Credit and Market Risk Division, (202) 874-4564, or Carl Kaminski, Senior Attorney, Legislative and Regulatory Activities Division, (202) 874-5090.

Timothy W. Long
Senior Deputy Comptroller for Bank Supervision Policy
and Chief National Bank Examiner

¹ Pub. L. No. 111-203, 124 Stat. 1376, section 939A (July 21, 2010).

Related Links

- [Joint Capital ANPR](#)
- [OCC Investments and Other Regulations ANPR](#)

Proposed Rules

Federal Register

Vol. 75, No. 164

Wednesday, August 25, 2010

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket ID: OCC–2010–0016]

RIN 1557–AD35

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–1391]

RIN 7100–AD53

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AD62

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[Docket ID: OTS–2010–0027]

RIN 1550–AC43

Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies

AGENCIES: Office of the Comptroller of the Currency (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision (OTS).

ACTION: Joint Advance Notice of Proposed Rulemaking.

SUMMARY: The regulations of the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) (collectively, the agencies) include various references to and requirements

based on the use of credit ratings issued by nationally recognized statistical rating organizations (NRSROs). Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), enacted on July 21, 2010, requires the agencies to review their regulations that require the use of an assessment of creditworthiness of a security or money market instrument and make reference to, or have requirements regarding, credit ratings. The agencies must then modify their regulations to remove any reference to, or requirements of reliance on, credit ratings in such regulations and substitute in their place other standards of creditworthiness that the agencies determine to be appropriate for such regulations.

This advanced notice of proposed rulemaking (ANPR) describes the areas in the agencies' risk-based capital standards and Basel changes that could affect those standards that make reference to credit ratings and requests comment on potential alternatives to the use of credit ratings.

DATES: Comments on this ANPR must be received by October 25, 2010.

ADDRESSES: Comments should be directed to:

OCC: Because paper mail in the Washington, DC area and at the Agencies is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or e-mail, if possible. Please use the title "Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies" 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–2010–0016,” and click “Search.” On “View By Relevance” tab at bottom of screen, in the “Agency” column, locate the [insert type of rulemaking action] 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–2010–0016” 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,” and in “Enter Keyword or ID Box,” enter Docket ID “OCC–2010–0016,” 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.

Board: You may submit comments, identified by Docket No. R-1391, by any of the following methods:

- *Agency Web site*: <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- *Federal eRulemaking Portal*: <http://www.regulations.gov>. Follow the instructions for submitting comments.

- *E-mail*: regs.comments@federalreserve.gov. Include docket number in the subject line of the message.

- *FAX*: (202) 452-3819 or (202) 452-3102.

- *Mail*: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (20th and C Street, NW.) between 9 a.m. and 5 p.m. on weekdays.

FDIC: You may submit comments on the ANPR, by any of the following methods:

- *Agency Web site*: <http://www.FDIC.gov/regulations/laws/federal/notices.html>. Follow instructions for submitting comments on the Agency Web site.

- *E-mail*: Comments@FDIC.gov. Include RIN # on the subject line of the message.

- *Mail*: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

- *Hand Delivery*: Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

Instructions: All comments received will be posted generally without change to <http://www.fdic.gov/regulations/laws/federal/propose.html>, including any personal information provided.

OTS: You may submit comments, identified by OTS-2010-0027, by any of the following methods:

- *Federal eRulemaking Portal*: "Regulations.gov": Go to <http://www.regulations.gov> and follow the instructions for submitting comments.

- *Mail*: Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: OTS-2010-0027.

- *Facsimile*: (202) 906-6518.

- *Hand Delivery/Courier*: Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention: OTS-2010-0027.

- *Instructions*: All submissions received must include the agency name and docket number for this rulemaking. All comments received will be posted without change, including any personal information provided. Comments, including attachments and other supporting materials received 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.

- *Viewing Comments Electronically*: Go to <http://www.regulations.gov> and follow the instructions for reading comments.

- *Viewing Comments On-Site*: You may inspect comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-6518. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10 a.m. and 4 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

FOR FURTHER INFORMATION CONTACT:

OCC: Mark Ginsberg, Risk Expert, Capital Policy Division, (202) 874-5070; or Carl Kaminski, Senior Attorney, Legislative and Regulatory Activities Division, (202) 874-5090, Office of the Comptroller of the Currency, 250 E. Street, SW., Washington, DC 20219.

Board: Thomas Boemio, Senior Project Manager, (202) 452-2982; William Treacy, Advisor, (202) 452-3859, Christopher Powell, Financial Analyst, (202) 912-4353, Division of Banking Supervision and Regulation; or Benjamin McDonough, Counsel, (202) 452-2036, or April Snyder, Counsel, (202) 452-3099; Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

FDIC: Bobby Bean, Chief, (202) 898-6705; Ryan Billingsley, Senior Policy Analyst, (202) 898-3797, Policy Section, Division of Supervision and Consumer Protection; or Mark Handzlik, Counsel, (202) 898-3990, or Michael B. Phillips, Counsel, (202) 898-3581, Supervision and Legislation Branch, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

OTS: Sonja White, Director, Capital Policy, (202) 906-7857, Teresa A. Scott, Senior Policy Analyst, Capital Policy, (202) 906-6478, or Marvin Shaw, Senior Attorney, Regulations and Legislation Division, (202) 906-6639, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

The agencies' regulations and capital standards include various references to and regulatory requirements based on the use of credit ratings issued by NRSROs.¹ 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 creditworthiness of a security or money market instrument; and (2) any references to or requirements in such regulations regarding credit ratings."² 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 creditworthiness as each respective agency shall determine as appropriate for such regulations." In developing substitute standards of creditworthiness, an agency "shall seek to establish, to the extent feasible, uniform standards of creditworthiness" for use by the agency, taking into account the entities it regulates that would be subject to such standards.³

¹ A nationally recognized statistical rating organization (NRSRO) is an entity registered with the U.S. Securities and Exchange Commission (SEC) as an NRSRO 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. On September 29, 2006, the President signed the Credit Rating Agency Reform Act of 2006 ("Reform Act") (Pub. L. 109-291) into law. The Reform Act requires a credit rating agency that wants to represent itself as an NRSRO to register with the SEC.

² Public Law 111-203, 124 Stat. 1376, section 939A (July 21, 2010). Although the agencies have conducted a broad review of their risk-based capital regulations to identify all references to credit ratings and consider alternatives, the agencies note that section 939A of the Dodd-Frank Act limits the required review of agency regulations to those pertaining to a creditworthiness assessment of a security or money market instrument.

³ Id.

Through this advanced notice of proposed rulemaking (ANPR), the agencies are seeking to gather information as they begin to work toward revising their regulations and capital standards to comply with the Act. This ANPR describes the areas in the agencies' general risk-based capital rules,⁴ market risk rules,⁵ and advanced approaches rules⁶ (collectively, the risk-based capital standards) where the agencies rely on credit ratings, as well as the Basel Committee on Banking Supervision's (Basel Committee) recent amendments to the Basel Accord.⁷ The ANPR requests comment on potential alternatives to the use of credit ratings.⁸

II. Risk-Based Capital Standards

In June 2009, the agencies, as part of the international Joint Forum Working Group on Risk Assessment and Capital, participated in a stocktaking exercise to identify the use of credit ratings in relevant statutes, regulations, policies and guidance.⁹ The agencies have identified multiple regulations that must be brought into compliance with Section 939A of the Act. Included

among these regulations are the agencies' risk-based capital standards.

The agencies' risk-based capital standards reference credit ratings issued by NRSROs (credit ratings) in four general areas: (1) The assignment of risk weights to securitization exposures under the general risk-based capital rules and advanced approaches rules;¹⁰ (2) the assignment of risk weights to claims on, or guaranteed by, qualifying securities firms under the general risk-based capital rules;¹¹ (3) the assignment of certain standardized specific risk add-ons under the agencies' market risk rule;¹² and (4) the determination of eligibility of certain guarantors and collateral for purposes of the credit risk mitigation framework under the advanced approaches rules.¹³ In 2008, the agencies issued a notice of proposed rulemaking¹⁴ that sought comment on implementation in the United States of certain aspects of the standardized approach in the Basel Accord. The Basel standardized approach for credit risk (Basel standardized approach) relies extensively on credit ratings to assign risk weights to various exposures. (Throughout the rest of this ANPR,

references to the Basel standardized approach are references to the Basel Accord rather than the 2008 proposal.)

In 2009, the Basel Committee published the following documents that were designed to strengthen the risk-based capital framework in the Basel Accord: *Revisions to the Basel II Market Risk Framework* (Revisions Document); *Enhancements to the Basel II Framework* (Enhancements Document); and *Strengthening the Resilience of the Banking Sector*.¹⁵ In the Enhancements Document, the Basel Committee introduced operational criteria to require banking organizations¹⁶ to undertake independent analyses of the creditworthiness of their securitization exposures.¹⁷ Implementation in the United States of the changes to the Basel Accord contained in the Revisions Document would be significantly affected by the need for the agencies to comply with section 939A of the Act.

The table below provides an overview of where credit ratings are referenced and used as the basis for a capital requirement along two dimensions of exposure category and capital framework.

Exposure category	General risk-based capital rules	Advanced approaches rules	Market risk rules	Basel standardized approach	Basel market risk framework (revisions document)
Sovereign .....	.....	.....	X	X	X
Public Sector Entity .....	.....	.....	X	X	X
Bank .....	.....	.....	.....	X	X
Corporate	X	.....	X	X	X
Securitization	X	X	X	X	X
Credit Risk Mitigation	X	X	.....	X	.....

⁴ See 12 CFR part 3, appendix A (OCC); 12 CFR parts 208 and 225, appendix A (Board); 12 CFR part 325, appendix A (FDIC); 12 CFR part 567, subpart B (OTS).

⁵ See 12 CFR part 3, appendix B (OCC); 12 CFR parts 208 and 225, appendix E (Board); 12 CFR part 325, appendix C (FDIC); OTS does not have a market risk rule.

⁶ See 12 CFR part 3, appendix C (OCC); 12 CFR part 208, appendix F and 12 CFR part 225, appendix G (Board); 12 CFR part 325, Appendix D (FDIC); 12 CFR part 567, Appendix C (OTS).

⁷ See "International Convergence of Capital Measurement and Capital Standards, a Revised Framework, Comprehensive Version," the Basel Committee on Banking Supervision, June 2006. The full text is available on the Bank for International Settlement's Web site, <http://www.bis.org/publ/bcbs128.htm>.

⁸ The OCC is planning to issue a similar advance notice of proposed rulemaking addressing alternatives to the use of external credit ratings in the regulations of the OCC.

⁹ See, "Stocktaking on the use of credit ratings", The Joint Forum. The full text is available on the

Bank for International Settlement's Web site, <http://www.bis.org/publ/joint22.htm>.

¹⁰ See 12 CFR part 3, Appendices A and C (OCC); 12 CFR part 208, Appendices A and F and 12 CFR part 225, Appendices A and G (Board); 12 CFR part 325, Appendix A and 12 CFR part 325 Appendix D (FDIC); 12 CFR part 567, subpart B and Appendix C (OTS).

¹¹ See 12 CFR part 3, Appendix A, section 3(a)(2)(xiii) (OCC); 12 CFR parts 208 and 225, Appendix A, section III.C.2 (Board); 12 CFR part 325, Appendix A, section II.C. (FDIC); 12 CFR 567.6 (OTS).

¹² See 12 CFR part 3, Appendix B, section 5 (OCC); 12 CFR parts 208 and 225, Appendix E, section 5 (Board); 12 CFR part 325, Appendix C, section 5 (FDIC); OTS does not have a market risk rule.

¹³ See the definition of "eligible double default guarantor," "eligible securitization guarantor," and "financial collateral" in the agencies advanced approaches rules. 12 CFR part 3, Appendix C, section 2 (OCC); 12 CFR part 208, Appendix F section 2 and 12 CFR part 225, Appendix G section 2 (Board); 12 CFR part 325, Appendix D section 2

(FDIC); 12 CFR part 567, Appendix C, section 2 (OTS).

¹⁴ 73 FR 43982.

¹⁵ See "Revisions to the Basel II Market Risk Framework" (July 2009, Basel Committee); "Guidelines for Computing Capital for Incremental Risk in the Trading Book" (July 2005, joint publication of the Basel Committee and International Organization for Securities Commissioners); "Enhancements to the Basel II Framework" (July 2009, Basel Committee); and "Strengthening the Resilience of the Banking Sector" (December 2009, Basel Committee).

¹⁶ For simplicity, and unless otherwise indicated, this ANPR uses the term "banking organization" to include banks, savings associations, and bank holding companies.

¹⁷ These operational criteria would require a bank to have a comprehensive understanding of the risk characteristics of its individual securitization exposures; be able to access performance information on the underlying pools on an on-going basis in a timely manner; and have a thorough understanding of all structural features of a securitization transaction. Enhancements Document, paragraphs 565(i)-(iv).

III. Request for Comment

This ANPR seeks comment on standards of creditworthiness other than credit ratings that may be used for purposes of the risk-based capital standards. The various alternative approaches in this ANPR may present challenges of feasibility in varying degrees. The agencies would appreciate commenters' views on the feasibility of implementing the suggestions for alternative approaches in this ANPR and any methodologies that commenters may provide.

a. Creditworthiness Standards

Section 939A of the Act requires the agencies to establish, to the extent feasible, uniform standards of creditworthiness to replace references to, or requirements of reliance on, credit ratings for purposes of the agencies' regulations. The agencies are therefore considering alternative creditworthiness standards, including those currently in use in the agencies' regulations, supervisory guidance, and market practices. The agencies recognize that any measure of creditworthiness will involve a tradeoff among the principles listed below. For example, a more refined differentiation of risk might be achievable only at the expense of greater implementation burden. In evaluating any standard of creditworthiness for purposes of determining risk-based capital requirements, the agencies will, to the extent practicable and consistent with the other objectives, consider whether the standard would:

- Appropriately distinguish the credit risk associated with a particular exposure within an asset class;
 - Be sufficiently transparent, unbiased, replicable, and defined to allow banking organizations of varying size and complexity to arrive at the same assessment of creditworthiness for similar exposures and to allow for appropriate supervisory review;
 - Provide for the timely and accurate measurement of negative and positive changes in creditworthiness;
 - Minimize opportunities for regulatory capital arbitrage;
 - Be reasonably simple to implement and not add undue burden on banking organizations; and
 - Foster prudent risk management.

Question 1: The agencies seek comment on the principles that should guide the formulation of creditworthiness standards. Do the principles provided above capture the appropriate elements of sound creditworthiness standards? How could the principles be strengthened?

b. Possible Alternatives to Credit Ratings in the Risk-Based Capital Standards

The agencies' existing risk-based capital standards include a range of approaches to differentiating credit risk. At one end of the spectrum, the agencies' general risk-based capital rules provide a relatively simple approach to measuring and differentiating risk based on the use of broad risk buckets. This approach requires all corporate exposures, for example, to receive the same risk weight, regardless of the variation in risks that exist across corporate exposures. This simple approach has limited risk sensitivity. At the other end of the spectrum, the agencies' advanced approaches rules require a banking organization to make its own assessment of the credit risk of a corporate exposure, subject to a number of agency-prescribed standards. This assessment is then used as an input into a supervisory formula to calculate minimum risk-based capital requirements. Relatively consistent assessments of risk across exposure categories and across banking organizations could be more difficult to achieve with this approach. The agencies' rules also incorporate other methods for assessing risk-based capital requirements, including the use of NRSRO ratings.

The agencies are considering a wide range of approaches of varying complexity and risk-sensitivity for developing creditworthiness standards for the risk-based capital standards. These include developing risk weights for exposure categories based on objective criteria established by regulators, similar to the current risk-bucketing approach of the general risk-based capital rules. The approaches also include developing broad qualitative and quantitative creditworthiness standards that banking organizations could use, subject to supervisory oversight, to measure the credit risk associated with exposures within a particular exposure category. These general approaches present certain advantages and disadvantages. In considering these approaches, the agencies will evaluate the extent to which the alternatives meet the principles described above.

Risk Weights Based on Exposure Category: One way to eliminate references to credit ratings in the risk-based capital standards would be for the agencies to delete all of the sections in their risk-based capital regulations that refer to credit ratings and retain the remainder of the general risk-based capital rules. Under this approach, all non-securitization exposures generally

would receive a 100 percent risk-weight unless otherwise specified. For example, certain sovereign and bank exposures would be assigned a zero percent or a 20 percent risk weight, respectively. Alternatively, the agencies could revise the risk-weight categories for exposures by considering the type of obligor, for example, sovereign, bank, public sector entity (PSE),¹⁸ as well as considering other criteria, such as the characteristics of the exposure, which could increase the risk sensitivity of the risk-based capital requirements by providing a wider range of risk-weight categories.

Exposure-Specific Risk Weights: Under this approach, banking organizations could assign risk weights to individual exposures using specific qualitative and quantitative credit risk measurement standards established by the agencies for various exposure categories. Such standards would be based on broad creditworthiness metrics. For instance, exposures could be assigned a risk weight based on certain market-based measures, such as credit spreads; or obligor-specific financial data, such as debt-to-equity ratios or other sound underwriting criteria. Alternatively, banking organizations could assign exposures to one of a limited number of risk weight categories based on an assessment of the exposure's probability of default or expected loss.

As part of an exposure-specific approach, the agencies are considering whether banking organizations should be permitted to contract with third-party service providers to obtain quantitative data, such as probabilities of default, as part of their process for making creditworthiness determinations and assigning risk weights. While this method could increase risk sensitivity, consistent application across exposure categories and across banking organizations could be more difficult to achieve.

Alternatively, the agencies could consider an approach for debt securities similar to that adopted by the National Association of Insurance Commissioners, under which a third party financial assessor would inform the agencies' understanding of risks and their ultimate determination of the risk-based capital requirement for individual securities.¹⁹ One potential drawback of this approach is excessive reliance on a single third-party assessment of risk.

¹⁸ A PSE exposure is an exposure to a state, local authority, or other government subdivision below the sovereign entity level.

¹⁹ See <http://www.naic.org/rmbs/index.htm#background>.

Regardless of the approach used, the agencies would establish strict quantitative and qualitative criteria to ensure that the methodology employed is consistent with safe and sound banking practices.

Question 2: What are the advantages and disadvantages for each of these general approaches? What, if any, combination of the approaches would appropriately reflect exposure categories and the sophistication of individual banking organizations? What other approaches do commenters believe would meet the agencies' suggested criteria for a creditworthiness standard? If increasing reliance is placed on banking organizations to assign risk weights for credit exposures using the types of approaches described above, how would the agencies ensure consistency of capital treatment for similar exposures? How could the use of third-party providers be implemented to ensure quality, transparency, and consistency?

c. Exposure-Specific Options for Measuring Creditworthiness

The broad approaches discussed above could be applied in various ways across the agencies risk-based capital rules as well as existing exposure categories. While the range of approaches is potentially applicable to all exposure categories, the sections below provide a more detailed discussion of how the approaches might be implemented by exposure categories.

i. Sovereign Exposures

The agencies' general risk-based capital rules risk weight exposures to sovereign entities based on membership in the Organization for Economic Cooperation and Development (OECD).²⁰ However, under the Basel standardized approach, a banking organization would assign a risk weight to a sovereign exposure based on the external credit rating of the sovereign by a credit rating agency.²¹ The current market risk rule and the Basel modified market risk framework also make use of ratings for sovereign exposures.

There are several alternative methodologies that could be used to risk weight sovereign exposures that have

different implications for risk sensitivity. One option would be to assign risk weights for sovereign exposures based on whether the sovereign is a member of an organization other than the OECD, such as the G-20 or the Basel Committee on Banking Supervision, or whether it participates in the International Monetary Fund (IMF) New Arrangements to Borrow. This type of approach would be operationally simple, but would not recognize differences in creditworthiness among the individual member nations within an organization. An additional degree of risk sensitivity could be incorporated into this approach by adding additional criteria beyond membership in a given organization. For instance, a higher risk weight could be assigned to an exposure to a sovereign entity if it had restructured its debt within a specified period of time or if its creditworthiness deteriorated based on some market indicator (for example, credit spreads).

The agencies could also consider incorporating into standards of creditworthiness country risk classifications generated by the OECD, the World Bank, or a similar organization. This approach could assign risk weights according to the relative credit risk of each risk classification or designation. Under such an approach, exposures to sovereigns classified as having lower credit risk would receive lower risk weights, and exposures classified as higher risk would receive higher risk weights.

A third option would be to differentiate the credit risk of sovereign exposures based on certain key financial and economic indicators. For example, risk weights could be assigned based on one or more ratios such as gross debt per capita, real gross domestic product growth rate, or government debt and foreign reserves. Such a treatment would require the agencies to select specific ratios and acceptable data sources, for example, from the IMF or the OECD.

Question 3: What are the advantages and disadvantages of these alternative methods? How can the agencies ensure consistent and transparent implementation? Should the agencies consider other international organizations? Which financial and economic indicators should the agencies consider? What are the implications or potential unintended consequences? Are there other methods for assessing risk-based capital requirements for sovereign exposures that would meet the principles described in section III? Commenters are asked to provide

quantitative as well as qualitative support and/or analysis for proposed alternative methods.

ii. Public Sector Entity (PSE) exposures

The agencies' general risk-based capital rules assign risk weights to PSE exposures based on the repayment source for the exposure (for example, whether the exposure is a general obligation, revenue, or industrial revenue bond) and membership of the PSE's sovereign government in the OECD.²² Under the Basel standardized approach, PSE exposures would be risk weighted based on the credit rating of the exposure or the risk weight of the sovereign.²³ The current market risk rule and the Basel modified market risk framework also make use of credit ratings for PSE exposures.

One approach would be to continue to use the general risk-based capital rules' treatment of differentiating the risk of PSEs based on the type of exposure, the sovereign of incorporation, and by how revenues are collected for the PSE exposure.

Alternatively, the agencies could provide some incremental risk sensitivity by differentiating revenue bond issuers by type of service or business. As with sovereign exposures, risk weighting could be based on several financial and economic measures. For example, the agencies could assign risk weights based on one or more ratios, such as a relevant debt service obligation to cash flow ratio (for example, debt to revenue), and/or debt to market value of certain assets (for example, real estate). The agencies also could incorporate credit spreads to help differentiate credit risk among PSE exposures. Other options include permitting banking organizations to assign risk weights to PSE exposures based on the applicable risk weight of the sovereign of incorporation, or using data obtained from qualified third parties to inform creditworthiness assessments based upon a set of objective criteria established by the agencies.

Question 4: What are the advantages and disadvantages of these alternative methods for calculating risk-based capital requirements for PSE exposures? How can the agencies ensure consistent and transparent implementation? Which services and businesses, or financial and economic measures, should the agencies consider? What are the implications or potential for

²⁰ See 12 CFR part 3, Appendix A, section 3(a) (OCC); 12 CFR parts 208 and 225, Appendix A, section III.C (Board); 12 CFR part 325, Appendix A, section II.C. (FDIC); 12 CFR 567.6 (OTS). The OECD-based group of countries comprises all full members of the OECD, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow. The list of OECD countries is available on the OECD Web site at <http://www.oecd.org>.

²¹ Basel Accord, Paragraphs 53–56.

²² See 12 CFR part 3, Appendix A, section 3(a) (OCC); 12 CFR parts 208 and 225, Appendix A, section III.C (Board); 12 CFR part 325, Appendix A, section II.C (FDIC); 12 CFR 567.6 (OTS).

²³ Basel Accord, paragraphs 57–58.

unintended consequences? Are there other methods for assessing risk-based capital for PSE exposures in a relatively risk sensitive manner that would meet the principles described in section III? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

iii. Bank Exposures

The agencies' general risk-based capital rules generally assign a 20 percent risk weight to exposures to U.S. depository institutions and foreign banks.²⁴ Long-term exposures to banks not incorporated in OECD countries are assigned a 100 percent risk weight. Under the Basel standardized approach, bank exposures would be risk weighted based either on the risk weight of the sovereign or the credit rating of the exposure.²⁵ The market risk rule and the Basel modified market risk framework also use ratings for bank exposures.

One option for risk weighting bank exposures is to continue to use the general risk-based capital treatment, which bases the risk weight for bank exposures on whether the sovereign where the bank is incorporated is a member of the OECD. Another method for risk weighting bank exposures could be based on several financial measures and market indicators. For example, the agencies could assign risk weights based on one or more ratios such as funding (for example, core deposits to total liabilities) and/or credit quality (for example, non-performing items to total assets). This method also could be supplemented for banks with publicly traded securities with market-based information such as a banking organization's unsecured bond spreads over comparable Treasury securities.

Question 5: What are the advantages and disadvantages of these alternative methods for calculating risk-based capital requirements for bank exposures? How can the agencies ensure consistent and transparent implementation? Which financial and market indicators should the agencies consider? What are the implications or potential for unintended consequences? Are there other methods for assessing risk-based capital for bank exposures in a relatively risk sensitive manner that would meet the principles described in section III? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

²⁴ See 12 CFR part 3, Appendix A, section 3(a)(2); 12 CFR parts 208 and 225, Appendix A, section III.C (Board); 12 CFR part 325, Appendix A, section II.C (FDIC); 12 CFR 567.6 (OTS).

²⁵ Basel Accord, paragraphs 60–64.

iv. Corporate Exposures

Under the agencies' general risk-based capital rules, corporate exposures generally²⁶ receive a risk weight of 100 percent,²⁷ whereas under the Basel standardized approach, banking organizations would be allowed to use credit ratings to assign risk weights to corporate exposures.²⁸ The current market risk rule and the Basel modified market risk framework also use credit ratings for corporate exposures.

One option for risk weighting corporate exposures would be to continue to use the treatment provided in the general risk-based capital rules and require banking organizations to risk weight all corporate exposures at 100 percent. Another method would be to differentiate the credit risk of corporate exposures based on financial and economic measures appropriate to the borrower. For example, the agencies could allow banking organizations to assign risk weights based on balance sheet or cash flow ratios, such as current assets to current liabilities, debt to equity, or some form of debt service to cash flow ratio (for example, current interest and maturities to current cash flow from operations). Alternatively, some corporate exposures for publicly traded firms could be risk weighted on the basis of market-based measures, such as credit spreads and equity-price implied default probability, and measures of capital adequacy and liquidity.

Finally, the agencies could allow banking organizations to assign risk weights based upon a more flexible set of objective criteria that the agencies would establish by rule. As a part of their process for making creditworthiness determinations and assigning risk weights, banking organizations would be allowed to consider external data, including credit analyses (but not credit ratings) provided by third parties, that met standards established by the agencies.

Question 6: What are the advantages and disadvantages of these alternative methods? What are the implications or potential for unintended consequences? If all banking organizations are allowed to calculate their own capital requirements for corporate exposures, how can the agencies ensure consistent and transparent implementation (for example, where there may be material

²⁶ Certain claims on, or claims guaranteed by, qualifying securities firms may receive a 20 percent risk weight.

²⁷ See 12 CFR part 3, Appendix A, section 3(a)(OCC); 12 CFR parts 208 and 225, Appendix A, section III.C (Board); 12 CFR part 325, Appendix A, section II.C (FDIC); 12 CFR 567.6(a)(1)(iv) (OTS).

²⁸ Basel Accord, paragraphs 66–68.

differences in how financial statements are typically presented or differences in chosen financial ratios)? What different approaches or other financial or market criteria would commenters recommend? Are there other methods for assessing risk-based capital for corporate exposures in a relatively risk sensitive manner that would meet the principles described in section III? Commenters are asked to provide quantitative, as well as qualitative, support and/or analysis for proposed alternative methods.

v. Securitization Exposures

Under the agencies' general risk-based capital rules, a banking organization may use credit ratings to assign risk weights to certain securitization exposures.²⁹ Generally, when a banking organization cannot, or chooses not to use the ratings-based approach, it must either "gross-up" the exposure or hold dollar-for-dollar capital against the exposure. These latter methods are designed to capture the risk of unrated or low rated exposures that typically are subordinate in the capital structure of a securitization. Under the advanced approaches rules and the Basel standardized approach, a banking organization is required to use a ratings-based approach when available to assign risk weights to traditional and synthetic securitization exposures.³⁰ Both the advanced approaches rules and the Basel standardized approach also provide alternative approaches for determining the capital requirements for exposures that do not qualify for the ratings-based approach. The market risk rule and the Basel modified market risk framework also use credit ratings for securitization exposures.

Prior to the implementation of the recourse, direct credit substitutes, residual interests and mortgage- and asset-backed securities rule in 2001 (recourse rule),³¹ the agencies' general risk-based capital rules did not rely on credit ratings to determine risk weights for securitization exposures. In addition to establishing a risk-weighting framework based on credit ratings, the recourse rule established an alternative risk-weighting framework for certain

²⁹ See 12 CFR part 3, Appendix A, section 4 (OCC); 12 CFR parts 208 and 225, Appendix A, section III.B.3 (Board); 12 CFR part 325, Appendix A, section II.B.5 (FDIC); 12 CFR parts 567, subpart B (OTS).

³⁰ Basel Accord, Paragraph 567 (Basel standardized approach) and 12 CFR part 3, Appendix C, section 43(b) (OCC); 12 CFR part 208, Appendix F section 43(b) and 12 CFR part 225, Appendix G section 43(b) (Board); 12 CFR part 325, Appendix D, section 43(b) (advanced approaches rule) (FDIC); 12 CFR part 567, Appendix C, section 43(b) (OTS).

³¹ 66 FR 59617 (November 29, 2001).

securitization exposures (a gross-up treatment reflecting the risk of more subordinated tranches of securitizations). The agencies could apply the risk-based capital rules in effect prior to the implementation of the recourse rule, which would eliminate all references to credit ratings. This would result in all securitization exposures receiving the same risk weight regardless of the amount of subordination in the securitization structure. Alternatively, the agencies could:

- Require that banks apply the aforementioned “gross-up” treatment under which a bank must maintain capital against its securitization exposure, as well as against all more senior exposures that the bank’s exposure supports in the structure. The grossed-up exposure would then be assigned to the risk weight appropriate to the underlying securitized exposures.

- Differentiate the credit risk of the “grossed-up” securitization exposure based on financial and structural parameters of the underlying or reference pool of instruments, as well as the exposure itself. For example, risk weights could be assigned based on the securitization transaction’s overcollateralization ratio, interest coverage ratio, or priority in the cash flow waterfall.

- Assign the most senior securitization exposure in a transaction a risk weight based on the underlying exposure type and the aggregate amount of subordination that provides credit enhancement to the exposure. For example, the greater the amount of subordination, the lower the risk weight to which the senior exposure would be assigned. However, this approach would only apply to the senior-most tranche and would not distinguish between exposures with significant credit support and those where the support had been reduced or eliminated by losses.

- Adopt the Basel Committee’s approach to calculating capital requirements for securitization exposures that is based on the level of subordination and the type of underlying exposures in the Revisions Document. The approach would use a “concentration ratio” to set the minimum risk-based capital requirements for securitization positions. The concentration ratio is equal to the sum of the notional amounts of all the tranches divided by the sum of the notional amounts of the tranches junior to or *pari passu* with the tranche in which the position is held including that tranche itself. The capital requirement is 8 percent of the

weighted-average risk weight that would be applied to the underlying securitized exposures multiplied by the concentration ratio. If the concentration ratio is 12.5 or higher, the position would be deducted from capital. Under this approach, the capital requirement would be no less than that which would result from a direct exposure to the underlying assets.

- Design a risk-weighting approach based on a supervisory formula. Building on the capital requirements of the underlying exposures, the agencies could recognize multiple sources of risk related to securitizations and impose provisions that limit some forms of arbitrage. Under the advanced approaches rules, for example, banking organizations are allowed to use the supervisory formula approach (SFA) to calculate minimum regulatory capital requirements for certain securitization exposures.³² This approach uses exposure-specific inputs, including the capital requirement of the underlying exposures as if held directly by the banking organization. The inputs required for calculating the capital requirement of the underlying exposures are not always available for investing banking organizations. Nevertheless, the agencies could develop a simplified version of the SFA that could be applied by all banking organizations. Depending upon the parameters used in the SFA, this approach could increase risk sensitivity, as well as potentially increasing transparency in the securitization market.

Question 7: What are the advantages and disadvantages of these approaches for calculating risk-based capital requirements for securitization exposures? How can the agencies ensure consistent and transparent implementation? Which parameters or measures of subordination and structure should the agencies consider? What are the implications or potential for unintended consequences? How can the agencies ensure that an alternative approach meets the criteria for a creditworthiness standard? What other approaches or specific financial and structural parameters that would be appropriate standards of creditworthiness for securitization exposures? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

³² See 12 CFR part 3, Appendix C section 45 (OCC); 12 CFR part 208, Appendix F section 45 and 12 CFR part 225, Appendix G section 45 (Board); 12 CFR part 325, Appendix D, section 45 (FDIC); 12 CFR part 567, Appendix C, section 45 (OTS).

vi. Guarantees and Collateral

The agencies’ general risk-based capital rules generally limit the recognition of third-party guarantees to those provided by central governments, U.S. government agencies, banks, state and local governments of OECD countries, qualifying securities firms, and multilateral lending institutions and regional development banks. The general risk-based capital rules recognize collateral in the form of cash, securities issued or guaranteed by OECD central governments, securities issued by U.S. government agencies or U.S. government-sponsored agencies, and securities issued by multilateral lending institutions and regional development banks.³³

Under the Basel standardized approach, guarantor eligibility is based on the credit rating of the guarantor’s unsecured long-term debt security without credit enhancement that has a long-term external credit rating.³⁴ In addition, financial collateral includes, among other things, long-term debt securities that have an external credit rating of one category below investment grade or higher and short-term debt securities that have an external credit rating of at least investment grade.³⁵

The advanced approaches rules recognize the risk reducing effects of financial collateral and guarantees.³⁶ Eligible financial collateral includes long-term debt securities that have a credit rating of one category below investment grade or higher and short-term debt securities that have a credit rating of at least investment grade.³⁷ Guarantors eligible for double default treatment include those entities that a banking organization assigns a probability of default equal to or lower than the probability of default associated with a long-term credit rating in the third-highest investment grade category.³⁸

One option would be to expand the use of the recognition of collateral and

³³ See 12 CFR part 3, Appendix A (OCC), 12 CFR parts 208 and 225, Appendix A, section III.B (Board); 12 CFR part 325, Appendix A, section II.B.2 (FDIC); 12 CFR 567.6 (OTS).

³⁴ Basel Accord, paragraph 195.

³⁵ Id. at paragraph 145.

³⁶ See 12 CFR part 3, Appendix C, sections 33 and 34 (OCC); 12 CFR part 208, Appendix F sections 34 and 35 and 12 CFR part 225, Appendix G sections 34 and 35 (Board); 12 CFR part 325, Appendix D, sections 34 & 35 (FDIC); 12 CFR part 567, Appendix C, sections 34–35 (OTS).

³⁷ Id.

³⁸ See the definition of “eligible double-default guarantor” in the agencies’ advanced approaches rules. 12 CFR part 3, Appendix C, section 2 (OCC); 12 CFR part 208, Appendix F section 2 and 12 CFR part 225, Appendix G section 2 (Board); 12 CFR part 325, Appendix D, section 2 (FDIC); 12 CFR part 567, Appendix C, section 2 (OTS).

guarantees as provided in the general risk-based capital rules, that is, by substituting the risk weight appropriate to the guarantor or collateral for that of the exposure. This approach would have to be modified to exclude mention of external credit ratings for certain securities firms. The agencies could also incorporate into the recognition of collateral and guarantees some of the creditworthiness standards discussed above for sovereign, PSE, bank, and corporate exposures.

Question 8: What are the advantages and disadvantages of the alternative approaches? What are the implications or potential for unintended consequences? Are there other approaches that would more appropriately capture the risk-mitigating effects of collateral and/or guarantees without adding undue cost or burden? Commenters are asked to provide quantitative as well as qualitative supporting data and/or analysis for proposed alternative methods.

d. Burden

The agencies recognize that any measure of creditworthiness will involve a tradeoff among the objectives discussed in this ANPR. As previously noted, the agencies recognize that a more refined differentiation of creditworthiness may be achievable only at the expense of greater implementation burden. The agencies seek comment on the costs and burden that various alternative standards might entail. In particular, the agencies are interested in whether the development of alternatives to the use of credit ratings would involve, in most circumstances, cost considerations greater than those under the current regulations.

Question 9: What burden might arise from the implementation of alternative methods of measuring creditworthiness at banking organizations of varying size and complexity? Commenters are asked to provide quantitative as well as qualitative support for their burden estimates. In addition to the cost burden, the agencies seek comment on the feasibility of implementing various alternatives, particularly for community and mid-sized banks.

Dated: August 9, 2010.

John C. Dugan,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, this 10th day of August 2010.

Robert deV. Frierson,

Deputy Secretary of the Board.

Dated at Washington, DC, this 10th day of August 2010.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: August 11, 2010.

By the Office of Thrift Supervision.

John E. Bowman,

Acting Director.

[FR Doc. 2010-21051 Filed 8-24-10; 8:45 am]

BILLING CODE 4810-33-P; 6210-01-P; 6714-01-P; 6720-01-P

Proposed Rules

Federal Register

Vol. 75, No. 156

Friday, August 13, 2010

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

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

AGENCY: Office of the Comptroller of the Currency (OCC), Treasury.

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 October 12, 2010.

ADDRESSES: 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.¹ 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

¹ Public Law 111–203, 124 Stat. 1376, section 939A (July 21, 2010).

credit-worthiness for use by the agency, taking into account the entities it regulates that would be subject to such standards.²

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).³ For example, the OCC's regulations regarding permissible investment securities, securities offerings, and international activities each reference or rely upon NRSRO credit ratings.⁴ A description of these regulations is set forth below.

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."⁵ 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).⁶

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.⁷ However, there is no concentration limit for small business-related securities that are rated in the highest or second highest investment grade categories.⁸

Current Safety and Soundness Standards

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.⁹ Specifically, banks must consider the interest rate, credit, liquidity, price and other risks presented by investments, and the investments must be appropriate for the particular bank.¹⁰ 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.¹¹ Each bank also must maintain records available for examination purposes adequate to demonstrate that it meets the above requirements.¹²

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.¹³ 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.

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.¹⁴

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 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

² *Id.*

³ 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.

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

⁵ See, 12 CFR 1.5(e).

⁶ 12 CFR 1.2(d).

⁷ 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).

⁸ See, 12 CFR 1.3(e), 1.2(m).

⁹ 12 CFR 1.5.

¹⁰ 12 CFR 1.5(a).

¹¹ 12 CFR 1.5(b).

¹² 12 CFR 1.5(c).

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

¹⁴ OCC Bulletin 2002-19, "Unsafe and Unsound Investment Portfolio Practices."

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,¹⁵ 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

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.¹⁶ 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 NRSRO credit ratings. The SEC is preparing to undertake a similar review of its regulations in accordance with the Dodd-Frank Act.¹⁷ The OCC will consider any proposed and final changes to SEC regulations that are

¹⁶ 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.

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

¹⁵ See, 12 CFR 1.5(c).

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),¹⁸ 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."¹⁹ 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.²⁰

III. Request for Comment

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 credit-worthiness, 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 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, from 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

¹⁸ 12 U.S.C. 3102(g).

¹⁹ 12 U.S.C. 3102(g)(4).

²⁰ See, 12 CFR 28.15(a).

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 issuances²¹ and international banking activities.²²

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?

Dated: August 9, 2010.

By the Office of Comptroller of the Currency.

John C. Dugan,

Comptroller of the Currency.

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²¹ 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).

²² 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.