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**TESTIMONY OF**  
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**OFFICE OF THE COMPTROLLER OF THE CURRENCY**  
**Before the**  
**SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS**  
**COMMITTEE ON FINANCIAL SERVICES**  
**U. S. HOUSE OF REPRESENTATIVES**

**July 27, 2011**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

## **I. Introduction**

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, I appreciate the opportunity to testify about the initiatives the Office of the Comptroller of the Currency (OCC) has undertaken, and the challenges we are facing, in working to implement section 939A of the Dodd-Frank Act.

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) requires each federal agency, within one year of enactment, to review regulations that require the use of an assessment of the creditworthiness of a security or money market instrument, and any references to, or requirements in, those regulations regarding credit ratings. Each agency must then modify its regulations to remove any reference to, or requirement for, reliance on credit ratings and substitute alternative standards of creditworthiness that the agency determines are appropriate. Upon conclusion of the review, the Act requires each federal agency to transmit a report to Congress containing a description of any modification of any regulation made pursuant to section 939A. The OCC will be submitting its report today. My testimony today is based on the content of our report.

The OCC has reviewed its regulations and identified those that require the use of an assessment of the creditworthiness of a security or money market instrument and that reference or require the use of credit ratings. These regulations include interagency risk-based capital regulations, as well as OCC-specific regulations pertaining to national bank investment securities activities, securities offerings, and international banking activities. My testimony describes the use of credit ratings in these regulations and our efforts to

develop alternative creditworthiness standards pursuant to section 939A.<sup>1</sup> I will also discuss some of the challenges that the OCC and the other federal banking agencies face in developing appropriate alternatives. The difficulties presented in this regard include developing alternatives that do not add undue regulatory burdens and still appropriately measure credit risk, that provide for timely and accurate updates as the quality of a particular asset deteriorates or improves, and that are transparent and replicable so that banks of varying size and complexity, as well as supervisors, can arrive at the same assessment for similar assets.

## **II. Risk-Based Capital Regulations**

### ***A. References to Credit Ratings***

The federal banking agencies' risk-based capital standards reference credit ratings issued by nationally recognized statistical ratings organizations (NRSROs)<sup>2</sup> to determine appropriate capital requirements in four general areas:

- The assignment of risk weights to securitization exposures under the general risk-based capital rules and advanced approaches rules. Both approaches include provisions that differentiate among exposures by referencing credit ratings. As a general matter, highly-rated exposures receive lower capital requirements than

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<sup>1</sup> Pursuant to the Dodd-Frank Act, effective July 21, 2011, the OCC assumed responsibility for the on-going examination, supervision, and regulation of federal savings associations and for the rulemaking authority of the OTS relating to all savings associations, both state and federal. Currently, the OTS rules include references to credit ratings related to lending and investment in 12 CFR Part 560, and regulatory capital requirements in 12 CFR Part 567. The OTS issued an advance notice of proposed rulemaking addressing lending and investment on October 14, 2010 (75 Fed. Reg. 63107), and it joined the other federal banking agencies in issuing an advanced notice of proposed rulemaking addressing the regulatory capital requirements on August 25, 2010 (75 Fed. Reg. 52283). Going forward, the OCC's efforts pursuant to section 939A will cover both OCC and OTS rules and will take into account comments received in response to the OTS notices.

<sup>2</sup> An 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.

lower-rated exposures.<sup>3</sup>

- The assignment of risk weights to claims on, or guaranteed by, qualifying securities firms under the general risk-based capital rules. Under the general risk-based capital rules, a lower risk weight is applied to most claims on, or guaranteed by, a securities firm, provided the firm has a credit rating that is in one of the three highest investment-grade categories used by the NRSRO.<sup>4</sup>
- The assignment of certain standardized specific risk add-ons under the agencies' market risk rule. As a general matter, debt instruments that are rated investment grade by one or more NRSROs are considered "qualifying" and receive a lower specific risk add-on under the standard option.<sup>5</sup>
- The determination of eligibility of certain guarantors and collateral for purposes of the credit risk mitigation framework under the advanced approaches rules. Under the advanced approaches risk-based capital rule, the definition of financial collateral includes various types of securities that have external ratings of at least investment grade and, in certain instances, recognition of guarantees are based on NRSRO ratings assigned to a guarantor.<sup>6</sup>

The federal banking agencies' risk-based capital regulations are based on a framework published by the Basel Committee on Banking Supervision (Basel Committee), a committee of banking supervisory authorities,<sup>7</sup> which was established by

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<sup>3</sup> See 12 CFR Part 3, appendices A (general risk-based capital rules) and C (advanced approaches rules).

<sup>4</sup> See 12 CFR Part 3, Appendix A, section 3(a)(2)(xiii).

<sup>5</sup> See 12 CFR Part 3, Appendix B, section 5.

<sup>6</sup> 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.

<sup>7</sup> The Basel Committee's members include Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands,

the central bank governors of the G–10 countries in 1975. The Basel Committee formulates broad supervisory standards and guidelines, including risk-based capital standards, to encourage convergence toward rigorous common approaches and standards.

In addition to affecting existing rules, Section 939A will also significantly affect future rulemaking by the U.S. banking agencies to conform our capital standards to recent changes and enhancements to the Basel Accord capital standards.

In 2008, the agencies issued a notice of proposed rulemaking<sup>8</sup> that sought comment on implementation in the U.S. of certain aspects of the standardized approach in the Basel Accord. The Basel standardized approach for credit risk is a more risk-sensitive approach than our current general risk-based capital rule and relies extensively on credit ratings to assign risk weights to various exposures.

In 2009, in response to the financial crisis, the Basel Committee published the following documents that revise and strengthen the Basel risk-based capital framework: 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.<sup>9</sup> The *Enhancements* Document introduced operational criteria to require banking organizations<sup>10</sup> to undertake independent analyses of their securitization exposures. These operational criteria require a bank to have a comprehensive understanding of the risk characteristics of its individual securitization exposures; to be

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Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

<sup>8</sup> 73 FR 43982.

<sup>9</sup> 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).

<sup>10</sup> For simplicity, and unless otherwise indicated, the term “banking organization” includes banks, savings associations, and bank holding companies.

able to access performance information on the underlying pools on an on-going basis in a timely manner; and to have a thorough understanding of all structural features of a securitization transaction.<sup>11</sup> The *Enhancements* document also introduced higher risk-based capital requirements for re-securitization exposures. Moreover, the *Revisions* document increases capital charges for bank securitization exposures held for trading. The Basel Committee expects the standards under the *Enhancements* document and the *Revision* document, which still rely partially on credit ratings, to become effective in January 2012.

U.S. regulators cannot conform our capital standards to those agreed to internationally if section 939A precludes any reference to or reliance on credit ratings.

***B. Interagency Advance Notice of Proposed Rulemaking***

On August 25, 2010, the OCC and the other federal banking agencies published an advance notice of proposed rulemaking (interagency ANPR) seeking comment on several approaches of varying complexity and risk-sensitivity, for developing alternative creditworthiness standards for the provisions of the risk-based capital regulations that reference credit ratings.

At one end of the spectrum, the agencies requested comment on a relatively simple approach to measuring and differentiating risk using broad risk categories with limited risk sensitivity. For example, the approach would require all corporate exposures to receive the same risk weight, regardless of the variation in risks that exist across corporate exposures.

At the other end of the spectrum, the agencies suggested permitting a banking organization to assign risk weights to individual exposures using specific qualitative and

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<sup>11</sup> *Enhancements* document, paragraphs 565(i)–(iv).

quantitative credit risk measurement standards that could be established for various exposure categories based on broad creditworthiness metrics. For example, exposures could be assigned a risk weight using 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, a banking organization could assign exposures to one of a limited number of risk weight categories based on an internally-developed assessment of the exposure's probability of default or expected loss. Although this approach is risk sensitive, it likely would be difficult to achieve relatively consistent assessments of risk across exposure categories and across banking organizations.

Overall, commenters on the interagency ANPR expressed substantial concerns with the removal of credit ratings from the risk-based capital regulations and asserted that credit ratings can be a valuable tool for assessing creditworthiness. Commenters stated that any alternative creditworthiness standard used to determine risk-based capital requirements should be risk sensitive so as to not incent banks to engage in risk arbitrage.

A number of commenters noted that credit ratings are useful for measuring creditworthiness when appropriately used as a supplement to prudent due diligence processes. They observed that although easy-to-use alternatives have obvious appeal, such tools could create incentives to transform more robust credit analysis and due diligence into a simple compliance exercise. Simple alternatives could also fail to promote well-informed markets. A few of these commenters stated that the federal banking agencies should pursue other options, such as a legislative change, that would permit the agencies to continue using credit ratings in their regulations. These commenters stated that developing a suitable alternative to credit ratings would be

impossible without creating undue regulatory burden, which would be particularly acute for community banks, competitive inequities with international banking institutions, and inconsistencies with the international capital standards established by the Basel Committee.

Several commenters stated that exclusive reliance on credit ratings is inappropriate, especially for securitization exposures where measuring risk requires consideration of specific cash structures and collateral. However, instead of completely eliminating the use of credit ratings, these commenters suggested that the regulators should ensure that firms have sufficient information and conduct adequate due diligence to understand their risk exposure.

Many commenters especially stressed that risk-sensitive rules that require extensive modeling capabilities would place a disproportionate burden on community and regional banks. These banks generally do not have in-house the systems and staff capable of performing a level of analysis similar to that performed by credit rating agencies, and thus would have to hire third-party vendors. Further, rating services performed by third-party vendors would likely be similar to the services of NRSROs.

### ***C. Interagency Roundtable***

On November 10, 2010, the Federal Reserve Board hosted a roundtable discussion attended by staff and principals of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the OCC, as well as bankers, academics, asset managers, staff of credit rating organizations, and others to discuss alternate measures of creditworthiness.



Roundtable participants reiterated many of the concerns expressed and suggested by commenters in response to the interagency ANPR. These included concerns about the burden placed on community and regional banks to perform analyses similar to those conducted by credit rating organizations and larger banks. These participants asserted that any alternative standard should be easy to understand and use and allow for quick decision making. However, some participants also expressed concern that many creditworthiness measures that would be relatively simple to apply, such as credit default spreads, could introduce procyclicality. These participants suggested that a more complex multifactor analysis would be necessary to appropriately measure credit risk.

With regard to complex structured finance products, such as securitization positions, participants generally agreed that many banks needed to better understand the positions in which they invested. Several roundtable participants favored the use of cash flow analysis – which could be produced internally or provided by qualified third parties – to help determine risk-based capital requirements for securitization exposures. According to one panelist, the key components for conducting such an analysis would include an understanding of securitization structure and underlying loan characteristics, as well as timely surveillance. One participant favored a treatment for community banks that relied on observable inputs, such as bond spreads, rather than cash flow analysis that requires modeling.

### **III. OCC Non-Capital Regulations**

#### ***A. References to Credit Ratings***

In addition to the federal banking agencies' risk-based capital regulations, the OCC's regulations regarding permissible investment securities, securities offerings, and

international activities each reference or rely on NRSRO credit ratings.<sup>12</sup> In some instances, these regulations also use credit ratings as proxies for factors other than creditworthiness.

### *Investment Securities*

The OCC's investment securities regulations at 12 CFR Part 1 use credit ratings as a factor for determining the credit quality, marketability, and appropriate concentration levels of investment securities purchased and held by national banks. Under the OCC rules, an investment security must not be "predominantly speculative in nature." 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).

Credit ratings also are 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. The purpose of the investment grade rating requirement is to ensure that the security is of high credit quality and can be sold with reasonable promptness in the secondary market.

In addition, credit ratings are used to determine concentration limits for certain investment securities. For example, OCC rules limit holdings of "Type IV" securities of any one obligor that are rated in the third highest investment grade rating categories to

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

25 percent of the bank's capital and surplus.<sup>13</sup> However, there is no concentration limit for small business-related securities that are rated in the highest or second highest investment grade categories.

#### *Securities Offerings*

Securities issued by national banks are not covered by the registration provisions and several other SEC regulations that govern other issuers under the Securities Act of 1933. However, the OCC has adopted regulations at 12 CFR Part 16 to require disclosures related to national bank-issued securities. Part 16 includes references to "investment grade" ratings.

For example, section 16.6 provides an optional abbreviated registration system for nonconvertible bank-issued debt securities that meet certain criteria. The OCC designed the criteria, in part, 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. Among the criteria required for abbreviated registration, a security must be rated investment grade.

#### *International Banking Activities*

Pursuant to section 4(g) of the International Banking Act (IBA),<sup>14</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

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<sup>13</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>14</sup> 12 U.S.C. 3102(g).

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>15</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 U.S., and bankers’ 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.

***B. OCC Advance Notice of Proposed Rulemaking***

On August 13, 2010, the OCC published an advance notice of proposed rulemaking (OCC ANPR) that described the references to credit ratings in its regulations at 12 CFR Parts 1, 16, and 28 and requested comment on alternative creditworthiness standards.<sup>16</sup> The OCC’s ANPR described and requested comment on three general options for defining the term “investment grade.”

First, the OCC requested comment on an option that would permit a bank to determine that a security is investment grade by conducting its own internal credit analysis.

Second, the OCC outlined an alternative “investment grade” standard that would focus solely on a broader set of criteria than the current creditworthiness standard. The current standard focuses primarily on the timely repayment of principal and interest and the probability of default. A broader standard would recite many of the expectations described in OCC guidance materials, which emphasize that national banks must

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<sup>15</sup> 12 U.S.C. 3102(g)(4).

<sup>16</sup> 75 Fed. Reg. 49,423 (Aug. 13, 2010).

consider, as appropriate, credit, liquidity, and market risk, as well as any other risks presented by proposed securities activities.

Finally, the OCC proposed to permit banks to use internal loan classification systems to rate investment securities. This option would leverage off of the federal banking agencies' existing common risk-rating scale used to identify problem credits.

A majority of the commenters said that the OCC should continue to use credit ratings in its regulations. Most commenters argued that credit ratings are a valuable tool for banks – especially small banks – for measuring credit risk. Several commenters expressed doubt that any of the suggested alternatives for measuring creditworthiness would yield results that would be as useful and cost-effective as credit ratings, particularly after the passage of Dodd-Frank Act, which included measures adding to the SEC's oversight authority over NRSROs and requiring the SEC to draft new regulations governing NRSROs. A number of commenters stated that the OCC either should interpret the statute in a manner that would permit the continued use of credit ratings as one factor in the evaluation, or seek a legislative change that would permit banks to consider credit ratings as one of several factors when measuring credit risk.

Commenters on the OCC ANPR focused largely on two issues: competitive equity and compliance burden. Community and regional bank commenters argued that the inability to use credit ratings in evaluating investments could disadvantage them when compared with larger institutions that have advanced analytical capabilities. Larger internationally active banks expressed concern that they will be disadvantaged when compared to their foreign counterparts who may continue to use external credit ratings. Commenters also stated that developing internal rating systems to replace the long-

standing use of NRSRO credit ratings would involve costs greater than those under the current regulation, without a corresponding benefit to risk management. While commenters noted that cost and burden would be a factor for all banks, it is likely to be more pronounced for community and regional banks that may not have in-house the systems and staff capable of adopting and meeting new standards. If smaller financial institutions lack the staff and systems to comply with the new standard, commenters noted that they effectively would be prevented from purchasing many of the investment securities they currently are permitted to hold and which have not been a source of problems, including many types of municipal bonds. Thus, commenters stated that a cost-effective, simple standardized approach to measuring credit risk would be particularly important for community and regional banks.

#### **IV. Rulemaking Efforts and Challenges**

Section 939A directs the agencies both to remove references to and requirements of reliance on credit ratings from their regulations and to substitute in their place new standards of creditworthiness that the agencies determine to be appropriate. As many of the ANPR commenters and roundtable participants noted, developing such appropriate alternative standards of creditworthiness to replace references to credit ratings is proving an exceptionally challenging task.

In order to further safety and soundness, appropriate alternatives need to meet several objectives. They must appropriately measure credit risk, provide a basis for timely and accurate updates as the quality of a particular asset deteriorates or improves, and be transparent and replicable so that banks of varying size and complexity, as well as supervisors, can arrive at the same assessment for similar assets. In addition, appropriate

alternatives must be useable by banks of all sizes; they must not be so complex and burdensome that they are impractical and unduly burdensome for community and regional banks to use.

Finding appropriate substitutes for references to credit ratings is proving particularly challenging in connection with the risk-based capital standards. As previously noted, the federal banking agencies, in conjunction with other global supervisors through the Basel Committee, have sought to enhance the risk sensitivity of the risk-based capital standards. This is because less risk-sensitive rules may tend to encourage financial institutions to take on riskier, higher yielding assets to improve return on equity, without a corresponding increase in capital to offset the higher risk. However, absent the incorporation of third-party credit ratings, a more refined differentiation of credit risk may be achievable only at the expense of greater implementation burden – a burden that is likely to fall disproportionately on smaller banking institutions that do not have the resources to conduct credit analyses with the same level of detail as a credit rating organization or larger banking organizations.

The federal banking agencies have been reviewing the comments received in response to the interagency ANPR and have been examining ways in which they may implement the recent revisions to the international standards adopted by the Basel Committee, consistent with section 939A. If the U.S. agencies are unable to implement the Basel Committee changes that reference credit ratings, other jurisdictions may infer a lessening of the U.S. commitment to the Basel framework and the goal of a level playing field internationally.

Additionally, the OCC is continuing to work toward developing appropriate amendments to its regulations at 12 CFR Parts 1, 16, and 28.

We are proceeding thoroughly and carefully. To date, the use of credit ratings generally has provided a uniform, efficient, and reasonably transparent standard for assessing creditworthiness for most corporate and municipal exposures. Moreover, important steps have been taken to address areas where credit ratings were a factor in the recent financial crisis. Dodd-Frank has mandated major reforms for NRSROs; the SEC is setting new standards; and the OCC issued guidance in May 2009 re-emphasizing key principles of diligence and avoiding overreliance on NRSRO ratings, especially for more complex structured products.<sup>17</sup>

## **V. Conclusion**

Issues surrounding credit ratings, primarily with respect to complex structured products, were a significant factor in market overconfidence that contributed to subsequent losses in the markets for mortgage-backed securities in 2008-2009. The Dodd-Frank Act includes a number of important remedial measures to address this problem, including structural changes at the rating agencies, greater SEC oversight of the ratings process, and loan-level disclosure requirements to investors in asset-backed securities. Additionally, the OCC has issued guidance addressing the inappropriate overreliance on ratings.

In this context of enhanced regulation and oversight, the OCC believes the absolute prohibition against any references to ratings under section 939A goes further than is reasonably necessary. With appropriate operational and due diligence requirements, credit ratings can be a valuable factor to consider when evaluating the

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<sup>17</sup> OCC Bulletin 2009-15 (May 22, 2009).



creditworthiness of money market instruments and other securities. Precluding undue or exclusive reliance on credit ratings – rather than imposing an absolute prohibition to their use – would strike a more appropriate balance between the need to address the problems created by overreliance on credit ratings with the need to enact sound regulations that do not adversely affect credit availability or impede economic recovery.

Notwithstanding these concerns, we are continuing our work to revise our regulations to replace references to credit ratings with appropriate substitutes, as required by section 939A. As we undertake our revisions, we will be careful that the result is not a step backward in assuring that banks of all sizes conduct their activities in a safe and sound manner that reflects sound credit judgment and adequate capital for the risks they take.

I appreciate the opportunity to update the Subcommittee on the work we have done to date to implement section 939A of the Dodd-Frank Act, and to discuss the challenges we continue to face. I am happy to answer your questions.