§ 1605.2 [Amended]

2. Amend § 1605.2, by revising paragraph (b)(1)(iii) and adding paragraph (b)(1)(iv) to read as follows:

* * * * *

(b) * * *

(1) * * *

(iii) Determine the dollar value on the posting date of the number of shares the participant would have received had the contributions or loan payments been made on time. If the contributions or loan payments would have been invested in a Lifecycle fund that is retired on the posting date, the constructed share price shall equal the retired Lifecycle fund share price on December 31 of the retirement year, multiplied by the current L Income Fund share price, divided by the L Income Fund share price on December 31 of the retirement year. The dollar value shall be the number of shares the participant would have received had the contributions or loan payments been made on time multiplied by the constructed share price.

(iv) The difference between the dollar value of the contribution or loan payment on the posting date and the dollar value of the contribution or loan payment on the "as of" date is the breakage.

* * * * *

§ 1605.12 [Amended]

3. Amend § 1605.12, by revising paragraph (c)(2)(ii) to read as follows:

* * * * *

(c) * * *

(2) * * *

(ii) Multiply the price per share on the date the adjustment is posted by the number of shares calculated in paragraph (c)(2)(i) of this section. If the contribution was erroneously contributed to a Lifecycle fund that is retired on the date the adjustment is posted, the price per share shall equal the retired Lifecycle fund share price on December 31 of the retirement year, multiplied by the current L Income Fund share price, divided by the L Income Fund share price on December 31 of the retirement year.

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[FR Doc. 2010–25855 Filed 10–13–10; 8:45 am]

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DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 560

[Docket ID OTS–2010–0029]

RIN 1557–AC44

Alternatives to the Use of External Credit Ratings in the Regulations of the OTS

AGENCY: Office of Thrift Supervision (OTS), 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 under the Act to remove references or requirements of reliance on credit ratings and to substitute an alternative standard of credit-worthiness.

Through this ANPR, the OTS 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 November 15, 2010.

ADDRESSES: You may submit comments, identified by OTS–2010–0029, 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–2010–0029.
- *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–2010–0029.
- *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: William Magrini, Senior Project Manager, Risk Management Division, (202) 906–5744; or Marvin Shaw, Senior Attorney, Regulations and Legislation Division, Office of Chief Counsel, (202) 906–6639, Office Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

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

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

[2] *Id.*

This ANPR describes the areas where the OTS'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. On August 25, 2010, OTS and the other Federal banking agencies issued a separate joint advance notice of proposed rulemaking focused on the agencies' risk-based capital frameworks. (75 FR 52283)

II. OTS Regulations Referencing Credit Ratings

The non-capital regulations of OTS include various references to and requirements for use of a credit rating issued by a nationally recognized statistical rating organization (NRSRO).[3] For example, OTS's regulations regarding permissible investment securities reference or rely upon NRSRO credit ratings.[4] A description of these regulations is set forth below.

A. Investment Securities Regulations

The OTS's investment securities regulations at 12 CFR part 560 use credit ratings as a factor for determining the credit quality, liquidity/marketability, and appropriate concentration levels of investment securities purchased and held by savings associations. For example, under these rules, an investment security must be "Rated in one of the four highest categories as to the portion of the security in which the association is investing by a nationally recognized investment rating service at its most recently published rating before the date of purchase by the association."

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. A 144A security is generally deemed by OTS to be marketable if it is rated investment grade.

In addition, credit ratings are used to determine concentration limits on certain investment securities. For example, Part 560.40 limits holdings of corporate debt securities of any one issuer that are rated in the third or fourth highest investment grade rating categories to 15 percent of the association's capital and surplus. For securities that are rated in the highest or second highest investment grade categories, that limit is 25 percent of the savings association's capital and surplus.

Current Safety and Soundness Standards

In addition to current regulatory provisions that generally limit savings associations to purchasing securities that are rated investment grade, OTS policy guidance also require that savings associations make the investments consistent with safe and sound banking practices. Specifically, savings associations must consider the interest rate, credit, liquidity, price and other risks presented by investments and the investment must be appropriate for the particular savings association. Whether a security is an appropriate investment for a particular association will depend upon a variety of factors, including the association'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, an association must determine that there is adequate evidence that the obligor possesses resources sufficient to provide for all required payments on its obligations. Each association also must maintain records available for examination purposes adequate to demonstrate that it meets the above requirements.

OTS has issued guidance on safe and sound investment securities practices. OTS expects savings associations to understand the price sensitivity of securities before purchase (pre-purchase analysis) and on an ongoing basis.[5] 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, savings associations 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 savings association management should conduct. For securities with long maturities or complex options, management should understand the structure and price sensitivity of such securities purchased. For complex asset-backed securities, such as collateralized debt obligations, savings association management should ensure that they understand the security's structure and how the security will perform in different default environments.[6]

Alternative Standards

Four options for replacing the references to external credit ratings in OTS'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. OTS could adopt standards similar to those applied to unrated securities. Specifically, savings associations could be required to document, through their own credit assessment and analysis, that the security meets specified internal credit rating standards.

Under the current rules, a savings association may invest in a security if it is rated investment grade by an NRSRO. To demonstrate that a security is the credit equivalent of investment grade without using NRSROs ratings, a savings association would have to document, through its own credit assessment and analysis, that the security is a "pass" asset under its internal credit rating standards. However, because some internal 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.

If the OTS adopts a general credit-quality based test that does not rely on external credit ratings, it could require associations to determine that their investment securities meet certain credit quality standards. Savings associations 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 over the term of the security are low. OTS would require savings associations to document their credit assessment and analysis using systems and criteria similar to the savings association's internal loan credit grading system. These would be subject to examiner review and classification, similar to the process used for loan classifications.

[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 560.40 and 560.42.

[5] OTS Thrift Bulletin TB–13a "Management of Interest Rate Risk, Investment Securities, and Derivative Activities."

[6] OTS Thrift Bulletin TB 73a, "Complex Investment Securities."

If this alternative were adopted, OTS would continue to expect savings associations 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, OTS 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), would also establish criteria for marketability, liquidity, and price risk associated with market volatility.

OTS's current investment securities regulations and guidance emphasize ratings and marketability. An investment quality based standard could reflect some combination of these considerations and place quantitative limits on a savings association's investment securities activities based on the levels and types of risks in its portfolio. As with the credit quality standard, OTS could require associations to document their credit assessment and analysis using systems and criteria similar to their 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 OTS guidance, which warns that complex and illiquid instruments often can involve greater risk than actively traded, more liquid securities.[7] This higher potential risk arising from illiquidity is not always 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 savings association's internal risk rating systems. OTS could require a savings association 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 and savings associations 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.

Under the current rules, a security is not predominately speculative in nature if it is rated investment grade. Without the use of NSROs, savings associations would have to document, through their 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 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.

4. Reliance on External Information

A part of their process for making credit-worthiness determinations, savings associations would be allowed to consider external data, including credit analyses provided by third parties, that met standards established by OTS. In addition, alternative ways to measure credit risk might be to derive "implied ratings" from the market price of traded instruments. One type of such indicators is that derived from the equity prices. Another type is the bond market-implied rating base on the market price of debt instruments or credit derivatives such as credit default swaps.

Investors typically require a lower return for an investment with a lower risk of default. For example, the yield spread (difference between the yield on a corporate bond relative to a similar government bond) is often used as a measure of relative credit-worthiness, with reduction in the credit spread reflecting improvement in the issuer's perceived credit quality. Implied yield spreads could thus provide a useful market-based indication of credit-worthiness, provided that investors have sufficient information.

OTS would establish conditions under which savings associations could rely on external market data and information as part of their due diligence requirements.

III. Request for Comment

OTS is seeking public input as it begins reviewing its regulations pursuant to section 939A of the Dodd-Frank Act. In particular, OTS 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; OTS 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 part 560). Should the Dodd-Frank Act's requirement for the removal of references to credit ratings be construed to prohibit the use of credit ratings as a proxy for measuring other characteristics of a security, for example, liquidity or marketability?

2a. If continued reliance on credit ratings is permissible for purposes other than credit-worthiness, should OTS permit savings associations to continue to use credit ratings in their risk assessment process for the purpose of measuring the liquidity and marketability of investment securities, even though alternative measures to determine credit-worthiness would be prescribed?

2b. What alternative measures could the OTS and savings associations use to measure the marketability, and liquidity of a security?

3. What are the appropriate objectives for any alternative standards of credit-

[7] OTS Thrift Bulletin TB 73a, "Complex Investment Securities".

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. Provide for a reasonable and objective assessment of the likelihood of full repayment of principal and interest over the life of the security;

b. Foster prudent risk management;

c. Be transparent, replicable, and well defined;

d. Allow different banking organizations to assign the same assessment of credit quality to the same or similar credit exposures;

e. Allow for supervisory review;

f. Differentiate among investments in the same asset class with different credit risk; and

g. Provide for the timely and accurate measurement of negative and positive changes in investment quality, to the extent practicable.

Are these criteria appropriate? Are there other relevant criteria? Are there standards of credit-worthiness that can satisfy these criteria?

5. OTS 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 OTS should take into account? What additional burden, especially at community and regional savings associations, might arise from the implementation of alternative methods of measuring credit-worthiness?

7. The credit rating alternatives discussed in this ANPR differ, in certain respects, to those being proposed by OTS and other federal banking agencies for regulatory capital purposes.[8] OTS believes such distinctions are consistent with current differences in the application and evaluation of credit quality for evaluating loans and investment securities and those used for risk-based capital standards. Are such distinctions warranted? What are the benefits and costs of using different standards for different regulations?

Alternatives for Replacing References to Credit Ratings in Part 560

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

10. If OTS 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 OTS 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 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?

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

15. Should a savings association be permitted to consider credit assessments and other analytical data gathered from third parties that are independent of the seller or counterparty? What, if any, criteria or standards should the OTS impose on the use of such assessments and data?

16. Should a savings association be permitted to rely on an investment quality or credit quality determination made by another financial institution or another third party that is independent of the seller or counterparty? What, if any, criteria or standards should OTS impose on the use of such opinions?

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

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

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

Dated: October 6, 2010.

By the Office of Thrift Supervision.

John E. Bowman,

Acting Director.

[FR Doc. 2010–25845 Filed 10–13–10; 8:45 am]

BILLING CODE P

[8] 75 FR 52283, August 25, 2010.

SMALL BUSINESS ADMINISTRATION

13 CFR Part 107

RIN 3245–AF56

Small Business Investment Companies—Conflicts of Interest and Investment of Idle Funds

AGENCY: U.S. Small Business Administration.

ACTION: Proposed rule.

SUMMARY: The U.S. Small Business Administration proposes to revise a rule which prohibits a small business investment company (SBIC) from providing financing to an Associate, as defined in the rules, unless it first obtains a conflict of interest exemption from SBA. The revision would eliminate the requirement for an exemption in the case of a follow-on investment in a small business concern by an SBIC and an Associate investment fund, where both parties invested previously on the same terms and conditions and where the follow-on investment would also be on the same terms and conditions as well as in the same proportions. In addition, this rule would implement two provisions of the Small Business Investment Act. First, it would bring the public notice requirement for conflict of interest transactions into conformity with statutory requirements. Second, it would expand the types of investments an SBIC is permitted to make with its "idle funds" (cash that is not immediately needed for fund operations or investments in small business concerns). Finally, the rule would remove an outdated cross-reference and eliminate a section that exactly