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Merrill Lynch

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VIA ELECTRONIC MAIL

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

Re: Interagency Proposal on the Classification of Commercial Credit Exposures

Dear Mr. Feldman:

Merrill Lynch Bank USA ("MLBUSA" or the "Bank") appreciates the opportunity to comment on the joint proposal of the federal banking agencies (the "Agencies") relating to revisions to the classification system for commercial credit exposures (the "Proposal").

MLBUSA is an FDIC-insured Utah industrial bank and a subsidiary of Merrill Lynch & Co., Inc., a diversified holding company with operating subsidiaries engaged, among other things, in securities brokerage, capital markets, banking, investment research, asset management and insurance activities. MLBUSA and its subsidiaries engage in a broad range of commercial lending activities, including asset-based finance, commercial real estate lending, and equipment finance.

While we welcome all efforts to improve our internal risk assessment methods, we question whether the Proposal represents a meaningful enhancement over the current, single-tiered credit rating system when considering the potential significant costs and complexities of implementation. We would also like to emphasize the need for any final guidance to be consistent, to the extent possible, with Basel II for institutions adopting Basel II grading systems. Notwithstanding these concerns, if further clarified and improved upon, we believe final guidance can be of value to the Bank in its assessment of credit risk.

Background

The Proposal would replace the current classification system categories of "special mention," "substandard," and "doubtful" with a two-tiered framework. The first tier would use a *borrower rating*, which would measure the risk of the borrower defaulting on its obligations. At-risk loans would be categorized as either "marginal" (borrower may be harmed by changing economic conditions, but has the resources to recover); "weak" (borrower's ability to repay has deteriorated to a point where full repayment is doubtful); or "default" (payments have stopped and the loan has been placed on non-accrual or some of the debt has to be charged-off). All other loans would be categorized as "pass."

The second tier would use the following four *facility ratings*, which would be required to be applied only to loans to borrowers rated "default": (a) "remote" (no chance of loss even if borrower defaults because the lender has sufficient collateral to cover the debt); (b) "low" (lender expects to recover all but 5% of the loan principal); (c) "moderate" (losses are expected to be in the range of 5% to 30% of principal); and (d) "high" (losses may exceed 30% of principal).

When combined, the two ratings would determine whether a commercial credit exposure would be regarded as a "criticized" asset or instead as a "classified" asset.

Comments

General

Generally, we believe the Proposal's *borrower rating* system is a fair means of assessing a borrower's capacity to meet its financial obligations, although the examples relating to the new borrower ratings could use further clarification and illustrative examples. We also generally support the concept of a second tier to the rating system (*i.e.*, the facility rating), which we believe can further hone our credit risk management system. However, we are concerned that some of the granularity in this aspect of the Proposal, particularly relating to the "moderate" and "high" loss severity ratings, may lead to significant additional work without a corresponding benefit.

Costs

MLBUSA is capable of implementing the Proposal's framework. However, we emphasize that the Proposal represents a significant departure from current practices and would therefore likely lead to substantial additional costs and resources to comply, including, but not limited to, software/system upgrades, training of all credit personnel, and revision of applicable policies and procedures.

In addition, another possible implementation expense may be an increase to the Bank's allowance for loan and lease losses (ALLL). Based on our understanding of the Proposal, it appears that the "marginal" rating will pick up loans that are not currently rated "special mention." Similarly, the "weak" category would likely pick up loans that are currently rated "special mention." If these conclusions are correct, we could see a material migration downward, with a corresponding increase in reserves.

Default

We also note that the Proposal defines a borrower rating of "default" differently than that set out in the Basel II standards in the June 2004 Revised Framework. The Basel II definition of default is more strict than that proposed – *e.g.*, in addition to the conditions of an asset being placed in non-accrual status or the institution taking a full or partial charge off, Basel II requires a default rating to be applied where a specific reserve has been taken, a filing of bankruptcy or significant distressed restructuring has occurred, or in any case where the financial institution has reason to believe the credit is impaired.

Even recognizing that not all U.S. banking institutions will opt into the Basel II standards, maintaining two different definitions of default will likely lead to confusion and inconsistent application. For example, where shared national credits are involved, and one "Basel II opt in" institution is required by the rules to classify an obligor as defaulted, what would be the expected result for a "non-opt in" institution applying the more flexible rules of the Proposal?

This disconnect seems to be most evident where an institution conservatively takes a specific reserve against an otherwise performing asset. Under Basel II, the obligor must be rated "default" while in the Proposal the borrower may not necessarily be rated "default." This apparent discrepancy in definition could also lead to internal confusion across departments as institutions attempt to apply the definition accurately.

Similarly, the loss severity percentage estimates may not ultimately prove to be consistent with the Basel II Loss Given Default requirements and results. We would recommend that either these percentages be eliminated entirely, or at least be promulgated as indicative guidelines only, at least until such time as the institutions opting into Basel II can begin to produce data for comparative purposes.

Further Recommendations/Questions

Lastly, we would request that the Agencies consider the following additional recommendations and questions:

- The Proposal provides that a borrower rated "default" may be upgraded only if it meets its contractual debt service requirements for six consecutive months. This does not appear to contemplate circumstances in which the borrower provides additional collateral or other forms of credit support (*e.g.*, a third party guarantee). In such circumstances, would the borrower still be required to meet the six-month requirement?

- We recommend that the "marginal" borrower rating be further clarified with more objective standards. We are concerned that absent an objective standard, there is too much room for inconsistent categorizations among a lending group, the Bank's credit personnel, and the regulators.

- With respect to the facility ratings, the Proposal speaks of a "loss" rating, in addition to the rating of "remote," "low," "moderate," and "high." We suggest the final guidelines further explain how the "loss" rating should be applied. We note that it is not used in the facility loss severity grid contained in the Proposal.

- The Proposal provides that asset-based lending ("ABL") facilities secured by accounts receivable or "other collateral that readily generates sufficient cash to repay the loan" may be included in the "remote" category. It would be helpful if the final guidelines further clarified what forms of "other collateral" would satisfy this requirement. For example, would equipment inventory be suitable?

- Also with respect to ABL facilities, the Proposal provides that an institution must have, among other things, "dominion over" the cash generated from the conversion of collateral and "prudent" advance rates. It would be instructive if the final guidelines could further clarify the "dominion over" and "prudent" standards. For example, would springing liens (*i.e.*, a conditional right to demand collateral), which are commonly utilized in ABL facilities, qualify as dominion over the cash? If advance rates are supported by historical performance of the collateral pool, would this satisfy the prudent standard?

- Certain criteria delineated in the Proposal relating to the facility ratings are overly vague. For example, the term "coverage" as it relates to the "remote risk of loss" rating in the context of ABL facilities is defined to mean that a loan is "substantially over-collateralized," and the term "control" is simply defined, in part, as collateral "under the institution's control." In the context of credit risk assessment, ambiguous criteria such as these would be difficult to implement without further guidance or more objective standards.

- Generally, the various collateral liquidation timeframes appear arbitrary and do not provide the flexibility required to maximize return in a liquidation scenario. We would recommend that the Agencies consider more accommodating timeframes.

- In general, we recommend that loans secured by commercial real estate and compliant with the requirements of the Financial Institutions Reform, Recovery and Enforcement Act, should be treated similarly to other asset-based commercial loans.

- The Proposal provides that if a facility is unconditionally guaranteed, the guarantor's rating can be substituted for that of the borrower to determine whether a facility should be "criticized" or "classified." It is unclear whether the guarantor rating can be utilized while the rating is in a "pass" category. We would recommend that the Agencies clarify this point.

- The Proposal discusses the use of split facility ratings. In the context of cross-collateralized facilities, we would recommend that the final guidelines clarify that one facility rating would comply without the need for splitting ratings.

- We would recommend that the Agencies provide guidance on how these proposed ratings will affect ALLL calculations and how to apply the Statement of Financial Accounting Standards (SFAS) No. 114, "Accounting by Creditors for Impairment of a Loan."

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We appreciate the opportunity to comment on the Proposal and we would be pleased to offer any additional information that the Agencies may find helpful. Please feel free to contact the undersigned or my colleague, Paul Tufaro, Senior Counsel (212-449-1656), with any questions or comments.

Very truly yours,

John Swadba
Managing Director
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Merrill Lynch Bank USA

cc: Darryle Rude, Supervisor of Industrial Banks
Utah Department of Financial Institutions