American Bankers Association
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Docket ID OCC-2010-0016; RIN 1557-AD35

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
RIN 7100-AD 53

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064-AD62

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn: OTS-2010-0027; RIN 1550-AC43

Re: Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies, 75 Fed. Reg. 52283 (August 25, 2010)

Ladies and Gentlemen:

The American Bankers Association[1] welcomes the opportunity to comment on the agencies' *Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies* (ANPR). We appreciate the considerable task faced by the agencies in developing standards of creditworthiness in place of credit ratings for use in the agencies' capital rules. Indeed, we would encourage the agencies to adopt a standard that would employ credit ratings as one possible (albeit not mandatory) factor in determining the creditworthiness of an asset.

While we recognize that inadequacies in the issuance and use of credit ratings contributed to recent financial disruptions in the U.S. markets, we believe that a complete abandonment of credit ratings is ill-advised and an over-reaction. Other provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) and changes in industry practice render unnecessary the abandonment of the use of credit ratings as an indicator of creditworthiness. These changes include the following:

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[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees.

- Section 932 of DFA requires the credit rating agencies to provide more extensive and enhanced disclosure of their methodologies and to take actions to mitigate potential conflicts of interest.
- The SEC is required to establish an Office of Credit Ratings to protect users of credit ratings, promote accuracy in ratings, and ensure that ratings are not impacted by conflicts of interest. Eliminating credit ratings from the regulatory rules could frustrate the statutory purpose of the Office.
- Title IX of DFA imposes new liability standards on rating agencies, including a private right of action for securities law violations.

In addition, the industry has taken some pro-active measures to improve practices criticized in the recent financial market disruptions. For example, we understand that improvements to credit rating methodologies are being made and that incentive structures for rating agencies are changing. Based on recent press reports from the rating agencies, they have adopted new corporate governance procedures, enhanced controls for managing potential conflicts of interest, and new analytical tools.[2] These developments should allow for continued regulatory reliance on credit ratings, particularly if a market for "buy side" ratings could be developed.

Credit ratings are used internationally and have broad acceptance across markets. Abandoning completely the use of credit ratings in the capital rules adopted by U.S. regulators could have significant negative implications for the adoption of the internationally agreed Basel III standards and lead to competitive distortions across the international banking industry. It could also send the wrong signal to the other Basel member countries about the willingness of the U.S. to adhere to internationally agreed standards. It would be important to work with other national regulators to address the issue of reliance on credit ratings in order to facilitate the harmonization of rules across jurisdictions.

The impact of abandoning the use of credit ratings as a determinant of creditworthiness would be particularly burdensome for community and regional banks that generally do not have advanced analytical capabilities. Abandoning the use of credit ratings in the capital rules could make it impossible for many banks to participate in certain markets and could increase the cost of market access for all participants, with a disproportionate impact on community and regional institutions. Indeed, this is a view that has been expressed by former Comptroller of the Currency John Dugan.

Continued regulatory reliance on credit ratings need not mean blind reliance; rather, banks should be required to validate rating agency assessments with their own analytics, such as market-based measures for publicly traded firms or financial measures for firms with published financial statements. DFA does not preclude the use by banks of third party analytics – including credit ratings. The sophistication of these analytics should be appropriate to the size and complexity of the bank and its exposures. Banks with complex, structured exposures should

[2] See, e.g., www.standardandpoors.com/about-sp/leadership-actions.

be expected to have relatively more sophisticated analytics than those with simpler exposures, in keeping with the principle of proportionality. These analytics could be reviewed by supervisors as part of the examination process. In addition, the agencies could consider enhanced disclosure requirements that would facilitate the transparency of the use of ratings; these requirements could include descriptions of internal validation methodologies and governance practices around the use of ratings.

If the agencies determine that they must abandon completely the use of credit ratings in their capital rules, we offer the following comments:

- The agencies should develop both a standardized approach and an advanced approach and provide all banks with the option to use the standardized approach or, if the bank demonstrates the ability to implement an approach based on internal models and internal or external data sources, an advanced approach.

- A standardized approach should provide a transparent, defined, and simple approach that could be utilized by banks of all sizes and levels of complexity.

- Banks electing to adopt an advanced approach could be given the leeway to use alternatives to the credit default spread standardized approach. These banks would need to demonstrate that their alternative approaches are sufficiently robust.

- The risk weighting of securitization structures should reflect the characteristics of the underlying exposures, the level of subordination, and other relevant financial and structural differences across securitization structures.

Discussion

Agencies should develop a standardized and an advanced approach. In developing an alternative to the use of credit ratings in the risk-based capital rules, the agencies should provide for both a standardized and an advanced approach and allow banks the option to use one or the other on an all-or-nothing basis. A bank's election to use the standardized or the advanced approach could change over time, but the bank would not be permitted to "cherry pick" exposures and apply the standardized approach to some and the advanced approach to others.

Moreover, banks of any size and level of complexity could use the standardized approach if they so elected. Banks that wished to use the advanced approach would need to demonstrate to the appropriate federal banking agency their ability to develop and maintain an appropriately robust internal credit scoring model. Banks could select the rating criteria most meaningful to the types of exposures they hold and assign a corresponding internal risk weight. Of course, the risk weighting system would be subject to supervisory review and could be subject to backtesting in order to demonstrate its ability to indicate accurate levels of credit risk. Banks that fail to develop and maintain an appropriately robust advanced approach could be required to adopt the standardized approach by their regulators.

A standardized approach should provide a transparent, defined, and simple approach that could be utilized by banks of all sizes and levels of complexity. One possible basis for a standardized approach could involve the use of credit default spreads or other market indicators of creditworthiness. The use of market indicators would reduce reliance on a single source of information regarding creditworthiness. Alternatively, a standardized approach could be based on a risk-bucketing approach that would provide a transparent, defined, and simple approach for a wide range of banks.

Both alternatives have advantages and disadvantages. An approach based on spreads or other market indicators would have the advantage of a more refined level of granularity than an approach that assigns a wide range of exposures to a single category based on the nature of the exposure rather than its likelihood of default. Risk weights based on exposure category are akin to the Basel I approach in this respect and could lead to similar concerns about a search for yield within a particular risk bucket. Static risk weights would be less risk sensitive and less adaptive to changes in financial markets. An approach based on market indicators could be superior in capturing changes in credit quality in a timely manner.

One downside to the use of market indicators could be volatility in capital requirements, particularly for banking book assets. Moreover, credit spreads can change for reasons unrelated to default risk or creditworthiness. For example, risk premia unrelated to default risk are embedded in credit spreads. Spreads could increase the procyclicality of capital requirements, as they move in conjunction with the macroeconomy. From an implementation standpoint, not all companies have credit spreads, and it may be difficult for smaller banks to utilize a markets-based approach.

The ANPR also discusses an approach that would utilize a measure of creditworthiness developed by an international financial organization such as the World Bank or the International Monetary Fund. Measures used by these organizations may be used for very different purposes and bear less of a relationship to the credit exposures held by banks than would credit default spreads. Moreover, the use of indicators from a single source lacks the "market consensus" appeal of a broader-based measure. Indeed, reliance on any single third-party assessor of risk could lead to excessive reliance on one provider of information and could lead to many of the same problems that resulted in a lack of confidence in the credit rating agencies in the recent financial market disruptions.

For the advanced approaches, a wider range of internal models should be acceptable. Banks that have the appropriate risk modeling capabilities should be permitted, but not required, to adopt an internal models approach to risk weighting its credit exposures. Models could be designed to parallel the bank's risk management systems, providing consistency of regulatory and internal management approaches. This consistency helps to ensure that the data provided by the models is translated into management decision-making and actions. Broad regulatory parameters for internal models could be specified in order to help mitigate the risk that individual bank models could assign very different capital charges to similar assets.

If a bank elects to adopt an advanced approach, it should have the option to source the underlying data either internally or externally, in line with its risk management practices. Whether sourced internally or externally, regulators would have the ability to review the data underlying internal models in light of meeting the goals of a transparent, unbiased, replicable, and defined standard.

The risk weighting of securitization exposures should reflect the characteristics of the underlying exposures, the level of subordination, and other relevant structural and financial parameters. Application of the risk-based capital rules in effect prior to the implementation of the recourse rule, as suggested in the ANPR, would result in securitization structures receiving the same risk weight regardless of differing amounts of subordination in the structure. This is a non-risk-sensitive approach that neglects to consider a key determinant of creditworthinesss. This "step back in time" should be rejected.

The "gross-up" treatment that requires the maintenance of capital against all more senior exposures in the structure or approaches that assume the risk of a direct exposure to the underlying assets do not take into account the varying financial and structural differences across securitizations. Again, these approaches are insufficiently risk-sensitive and should be rejected.

A standardized approach to securitization exposures could be premised upon a simplified version of the supervisory formula approach, combined with substitution of the risk weight of the guarantor or collateral where those forms of risk mitigation are present. As the ANPR notes, this could increase both risk sensitivity and transparency. It would also be a relatively simple and straightforward approach to risk weighting that would minimize burden on banks.

For advanced approaches banks, a more sophisticated internal models approach could be developed by the bank with the concurrence of its primary federal regulator. This would allow a bank to design a risk weighting system that best reflects the characteristics of its exposures, subordination levels, and other relevant structural and financial parameters.

If you wish to discuss this letter, please contact the undersigned at mmonroe@aba.com or 202-663-5324.

Very truly yours,

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