American Bankers Association
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Attention: Comments/Legal ESS
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Jennifer J. Johnson
Secretary
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Washington, DC 20551

Re: Notice of Proposed Rulemaking Regarding Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions; 76 Federal Register 79380; December 21, 2011; FDIC: RIN 3064– AD70; FRB: Docket No. R–[1401]; OCC: Docket ID OCC–2010–0003

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] welcomes the opportunity to comment on the proposal by the Office of the Comptroller of the Currency, Federal Reserve Board, and the Federal Deposit Insurance Corporation (the Agencies) titled "Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions" (Market Risk Ratings Proposal). This proposal implements Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[2] which directs Agencies to remove references to credit ratings and to replace such ratings with an appropriate standard of creditworthiness.

The Market Risk Ratings Proposal will apply explicitly only to a select few of the largest banking institutions, but the alternatives to the use of ratings discussed in the proposal will likely be expanded to affect all banks subject to the generally applicable capital rules (General Capital Rules). ABA believes any requirements of general applicability should be first proposed in a rule of general applicability, otherwise, as in this case, the great majority of affected banks will

[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 2 million employees. The majority of ABA's members are banks with less than $165 million in assets. Learn more at www.aba.com.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203 (2010).

not be adequately on notice to consider the proposal, evaluate its affects, and share their comments. Thus, we believe that the Market Risk Ratings Proposal fails to provide adequately for the needed comprehensive rulemaking and should be withdrawn and re-proposed concurrently with the revisions to the General Capital Rules. The Agencies must not start discussing a fundamental shift in capital regulation that will effectively apply to all banks in a proposal that is purportedly applicable to just a few. Moreover, as this proposal relates to securitization positions, the Agencies have failed to define key terms, making it impossible for banks to provide comments fully addressing all relevant issues.

ABA is part of a joint association effort that is developing a comment letter that touches on the details of the Market Risk Ratings Proposal. ABA is supportive in general of the joint association letter. Based on our participation in that effort, we urge the agencies to use the methodologies discussed therein as the basis of a re-proposal of the rule. Moreover, if the Agencies propose the simplified supervisory formula approach (SSFA) for the General Capital Rules, or re-propose that approach in the market risk rules, the proposal should—

- Give banks the option to look through senior securitization positions to the underlying assets;
- Give banks the option to apply the gross-up method consistent with the current treatment of direct credit substitutes;
- Give banks the option to use a methodology more similar to the advanced approaches' supervisory formula;
- Not include a moving cumulative loss floor;
- Recognize the carrying value of a securitization position;
- Give banks the option to apply the direct reduction method for calculating a dollar-for-dollar capital charge;
- Include a test portfolio of examples representing various asset classes and levels of subordination;
- Include a study of the broader economic impact of the proposal to ensure it is consistent with generally accepted economic objectives and regulatory reform efforts; and,
- Not use Basel II's expansive definition of securitization.

I. Background.

Nationally Recognized Statistical Rating Organizations ratings are used throughout existing and proposed capital rules. The Market Risk Ratings Proposal directly applies only in the context of the market risk capital rules. At the FDIC Board Meeting approving the Market Risk Ratings Proposal, FDIC staff indicated that the Market Risk Ratings Proposal "would only apply to a select few of the largest institutions, less than 20 in total number."[3]

The Market Risk Ratings Proposal is part of the Agencies' effort to adopt international capital standards. In 2009, the Basel Committee finalized its "Revisions to the Basel II Market Risk

[3]FDIC staff responding to question by Acting Chairman Gruenberg. Transcript of FDIC Board Meeting. December 7, 2011, at time 28:20.

Framework" (Basel Revisions).[4] The Committee revised the market risk framework, in part, to eliminate arbitrage between the banking book (where the General Capital Rules apply) and trading book (where the market risk capital rules apply). Generally, the Basel Revisions apply the banking book capital treatment, a ratings-based approach, to securitizations held in the trading book.

Section 939A complicated the U.S. adoption of the Basel Revisions. On January 11, 2011, the Agencies issued a market risk proposal that adopted most of the Basel Revisions (January Proposal).[5] The Agencies did not propose the ratings-based approaches contained in the Basel Revisions, but instead installed a placeholder where ratings were used. The Market Risk Ratings Proposal is a supplement to the January Proposal, effectively filling in the placeholder.

For securitization positions, the Agencies have proposed an SSFA based on the supervisory formula approach included in the Agencies' Basel II advanced approaches rules. The SSFA, in theory, is designed to apply relatively high capital requirements to the more subordinated, risky tranches of a securitization that are the first to absorb losses and relatively lower requirements to the most senior positions. The SSFA relies on five inputs: 1) the weighted average risk weight of the underlying assets; 2) the attachment point of the relevant tranche; 3) the detachment point of the relevant tranche; 4) a numerical surcharge designed to penalize resecuritizations; and 5) cumulative losses. In addition, the SSFA is subject to a moving floor that is based on cumulative losses. We discuss our specific concerns with the SSFA in detail below.

II. The Market Risk Ratings Proposal Provides No Basis for Comprehensive Rulemaking.

A. The Market Risk Ratings Proposal's scope is uncertain.

The Market Risk Ratings Proposal has implications far beyond the market risk capital rules. U.S. regulators have not yet removed references to credit ratings in the General Capital Rules, but the market risk capital treatment and the general capital treatment are supposed to mirror each other to be internationally consistent. As such, Acting Comptroller Walsh stated at the FDIC Board Meeting—

> [T]he alternative approach to ratings that emerges from this process will also need to be applied to the banking book and subsequent rules for the Basel III framework. I think consistency between rules in these two areas is important to reduce opportunities for regulatory capital arbitrage, but it will also mean that the new approach will affect banks large and small. So we hope to receive feedback from the broader banking industry, not just the large banks, on whether this proposal represents a practical and effective alternative to ratings.

ABA appreciates how difficult it has been for the banking Agencies to develop substitutes for credit agency ratings. ABA also understands that the Agencies would like to demonstrate

[4] Available at http://www.bis.org/publ/bcbs158.htm.

[5] 76 Fed. Reg. 1890 (Jan. 11, 2011).

compliance with the capital framework agreed to by the Basel Committee. However, ABA believes it was inappropriate for the Agencies to start the discussion regarding a fundamental shift in capital regulation for all banks in a proposal that is directly applicable to just a few. The market risk capital rules are relatively obscure; the Agencies received just seven comments on the January Proposal. Most small banks are insufficiently aware of the Market Risk Ratings Proposal and therefore have been unable to evaluate its potential implications. ABA is concerned that by proceeding with the market risk rule the Agencies are predetermining the treatment of securitization positions subject to the General Capital Rules. The Agencies should not prioritize international compliance at the expense of small banks' right to participate amply in the rulemaking process.

B. Key SSFA inputs will likely change in the near future.

Banks cannot provide effective comments on the SSFA without clarification of how underlying assets will be risk-weighted. One of the five SSFA inputs is the weighted average risk weight of the underlying assets. Currently, under the General Capital Rules, most assets are relatively easy to risk-weight: mortgages are assigned a 50% risk weight and other assets are generally assigned a 100% risk weight. However, twice in the last six years the Agencies have proposed significant revisions to the General Capital Rules, including new approaches for risk-weighting mortgages. Although these proposals have not been finalized, the Agencies have signaled that they are again on the verge of proposing significant revisions to the General Capital Rules. ABA anticipates that these revisions will incorporate large portions of the Basel III framework as well as a new treatment for mortgages and corporate assets. It is impossible for banks accurately to determine and comment on the impact of the SSFA without knowing what these future treatments will entail.

C. The Market Risk Ratings Proposal fails to clearly define key inputs.

The Rating Proposal defines cumulative loss, one of the five SSFA inputs, as "the dollar amount of aggregate losses on the underlying exposures..." (emphasis added). Cumulative loss is a crucial concept in the Market Risk Ratings Proposal because, when compared to the capital requirement of the underlying exposures, it determines the SSFA floor. Although the definition is clear on a standalone basis, it does not appear to be the "cumulative loss" that is actually used in the SSFA. Table 7, *Minimum Specific Risk-Weighting Factor for a Position,* describes cumulative losses of principal on originally issued securities. The calculation of the floor does not use cumulative losses of the underlying exposures. This disconnect, combined with the uncertainty surrounding the capital treatment of the underlying exposures, makes it impossible to determine when the cumulative loss floor would be triggered.

Furthermore, the Market Risk Ratings Proposal fails to define the "attachment point," another one of the five SSFA inputs, in a meaningful way. The preamble describes the attachment point as the threshold at which credit losses would first be allocated to the positions. This is a general concept, not a definition. The preamble and rule text elaborate on this concept but do so in a contradictory manner. The preamble indicates that the SSFA does not recognize various credit enhancements, such as over-collateralization or excess spread. In contrast, the proposed rule text

indicates the attachment point may include a reserve account to the extent that cash is present in the account.

Banks cannot accurately determine and comment on the impact of the SSFA without clear definitions of the SSFA inputs. .

D. Errors in the Market Risk Ratings Proposal have confused many banks.

The misnamed SSFA is an extremely complex equation that could prove difficult for many banks to use. It is anything but simple. It is so complex that the Market Risk Ratings Proposal itself contains several errors. First, the SSFA in the preamble and the SSFA in the proposed rule text vary by a factor of 100. After close scrutiny, most banks have concluded that the rule text version is correct and the preamble version is incorrect. Second, further confusing the issue, the examples in the FDIC-approved version also included errors, although they were corrected in the federal register version. This is not to complain as much as it is to point out the tangible evidence of the complexity of the proposal.

E. The SSFA is not designed for complex structures.

The SSFA is an extremely complex equation that nevertheless is designed for only the most basic securitization structures. It is unclear how the Market Risk Ratings Proposal would be applied to revolving structures (including simple credit card trusts), delinked structures, collateralized debt obligations (CDOs),[6] or asset backed commercial paper. This lack of clarity has left banks to guess at the Agencies intent.

III. The SSFA Should Not Be Proposed for the General Capital Rules in its Current Form

A. If the Agencies propose the SSFA for the General Capital Rules, banks should be given the option to apply a look-through approach.

Under the General Capital Rules, senior securitization positions are not required to use a ratings based approach to determine capital treatment. Instead, banks may opt to apply a 100% risk weight even if the positions are poorly rated. In many contexts, this approach makes sense given that ratings are generally based on probability of default rather than loss given default. While a senior position might take a principal loss the position is unlikely to suffer substantial losses. Losses that may occur are often recognized through writing down the asset.

[6] It is particularly unclear how this proposal would apply to structured finance CDOs. The SSFA requires a bank to input the capital requirement of the underlying assets as if they were subject to the General Capital Rules. In a structured finance CDO, the underlying assets themselves are securitization positions currently subject to a ratings based approach in the General Capital Rules. In order to calculate a capital requirement, a bank must assume this proposal will predetermine the General Capital Rules proposal or use the existing ratings approach as a proxy knowing it will change. In short, holders of structured finance CDOs simply don’t have enough information to know what capital charges will be applied to them.

The SSFA, particularly the floor component, is an extremely blunt instrument. As a result, should the SSFA be proposed in the General Capital Rules, banks should be able to opt out of the SSFA and apply a look-through approach for senior securitization positions. This look-through approach would be based on the weighted average risk weight of the underlying assets. There is no reason why a senior position that benefits from credit enhancement should have a higher risk weight than the underlying pool that has no credit enhancement.

ABA acknowledges that not all senior securitization positions are low risk. Leading up to the crisis, many "thin" mezzanine mortgage-backed securities were packaged into CDOs. CDOs with high concentrations in mezzanine tranches took substantial losses because the underlying securities were highly correlated. ABA notes that the look-through approach discussed above would not provide a substantial capital benefit to high risk CDOs because the SSFA would have to be applied to the underlying mezzanine tranches. This would likely result in a conservative treatment for CDOs collateralized by high risk assets.

ABA believes this type of look-through approach should also be available for mortgage servicing cash advances if the Agencies propose the SSFA in the General Capital Rules. These positions tend to be short term and super credit enhanced. Due to the nature of mortgage servicing cash advances, this type of position grows when banks are forbearing on foreclosure. A high capital charge on these positions runs counter to generally accepted housing goals.

B. If the Agencies propose the SSFA for the General Capital Rules, banks should be given the option to use the "gross-up" treatment.

Under the General Capital Rules, non-senior securitizations can either apply a ratings based approach or the "gross-up" method. The gross-up method requires a bank to hold capital against all of the more senior positions. If the Agencies propose the SSFA for the General Capital Rules, they should continue to give banks the option to apply the gross-up method.

C. If the Agencies propose the SSFA for the General Capital Rules, banks should be given the option to use a methodology similar to the advanced approaches' supervisory formula.

The Agencies should develop both a workable standardized approach and an advanced approach based on Basel II methodologies. All banks should be given the option to use the standardized approach or, subject to supervisory approval, an advanced approach.

D. If the Agencies propose the SSFA for the General Capital Rules, the SSFA should not include a moving cumulative loss floor.

The SSFA is subject to a moving floor that is based on cumulative losses. This floor serves to limit the sensitivity inherent in the SSFA equation, because it applies equally throughout a securitization's capital structure. At its worst, for example, when cumulative losses in a mortgage backed security reach 6%, the floor applies a 1250% risk weight to the entire securitization structure. This makes no sense and would in fact be punitive and not reflective of reality. A 1250% risk weight implies a 100% risk of loss. In effect, what the regulators are

assuming is that if a pool suffers 6% in losses, the remaining 94% must be assumed a loss as well. This means that the floor would result in the application of 25 times the capital requirement that the General Capital Rules would apply to the underlying mortgages.[7] This outcome is a gross misalignment of capital and risk.

The SSFA floor should not be part of any future General Capital Rules proposal. A less bad approach for a floor in the General Capital Rules would be a risk sensitive floor that reflects the characteristics of the underlying assets, the level of subordination, and other relevant structural differences across securitization structures. But that would still be a suboptimal solution.

E. If the Agencies propose the SSFA for the General Capital Rules, the SSFA should recognize the carrying value of a securitization position.

In the Market Risk Ratings Proposal, the carrying value of a securitization position is not taken into account in determining the attachment point for purposes of the SSFA calculation. Where the carrying value of a securitization position is less than its par value, the credit risk of that position is reduced and the differential between the par value and the carrying value represents credit enhancement that is available to that position. Unless that credit enhancement is reflected in the attachment point for such position, the capital requirements for such positions will be overstated using the SSFA methodology. Should the Agencies propose the SSFA for the General Capital Rules, it would be appropriate to propose it with an adjustment to the attachment point for a securitization position with a carrying value that is lower than its par value.

F. If the Agencies propose the SSFA for the General Capital Rules, banks should continue to be allowed to use the direct reduction method for calculating a dollar-for-dollar capital charge.

It is unclear from the proposal whether or not banks will be allowed to continue to use the direct reduction method for calculating a dollar-for-dollar capital charge. The Call Reports currently allow two methods for calculating a dollar-for-dollar capital charge. The first assumes a bank's total risk-based capital ratio to be 8%. Alternatively, a bank may use the "direct reduction method" that allows it to calculate its capital requirement using the actual amount of the bank's total risk-based capital. The direct reduction method replicates a deduction from capital and does not result in a bank holding more capital than the asset's carrying value. For a bank whose risk-based capital ratios exceed the required minimums, it is normally preferable to use the direct reduction method. If the Agencies propose the SSFA for the General Capital Rules, banks should be allowed to use the direct reduction method to calculate a dollar-for-dollar capital charge.

[7] Assuming no loan loss reserve.

G. If the Agencies propose the SSFA for the General Capital Rules, the Agencies should provide a test portfolio of examples representing various asset classes and levels of subordination.

To ensure banks understand the SSFA, future SSFA proposals (or re-proposals) should be accompanied by a test portfolio of examples containing actual positions of varying seniority and asset classes.

H. If the Agencies propose the SSFA for the General Capital Rules, the agencies should conduct a study on the potential economic impact.

Given the potential negative economic impact of the methodologies in the Market Risk Ratings Proposal, ABA encourages the agencies to conduct an in-depth economic study before proposing the SSFA for the General Capital Rules. The study should not only focus on direct impacts of the proposal, but should also consider broader macro-economic impacts.

The SSFA grossly overstates the amount of capital that should be required for certain securitization exposures, including mortgage-backed securities. As a result U.S. banks will become less likely to invest in and hold these transactions. When they do, the costs of holding these assets will increase dramatically. Because banks are a vital financing source for many asset classes, the resulting negative effect on the availability of financing and the market liquidity for securitization exposures will be substantial. This negative effect on the availability and liquidity of credit to American consumers and businesses will have significant adverse effects on every asset class and potentially U.S. economic conditions. Moreover, if the SSFA is adopted in the General Capital Rules, it could trigger a downward spiral of securitization valuations. The study conducted by the Agencies should consider these impacts upon the broader U.S. economy (for example, employment) and upon regulatory reform (for example, Government Sponsored Enterprise reform).

I. If the Agencies propose the SSFA for the General Capital Rules, the proposal should not apply Basel II's definition of securitization outside the Basel II framework.

Basel II adopted an expansive definition of securitization. This definition not only captures standard securitization structures but also nearly any transaction that involves credit tranching. The Market Risk Ratings Proposal uses a similar definition of securitization. ABA has opposed this definition in the Basel II context and opposes its use in the market risk rules and General Capital Rules.[8]

IV. Conclusion

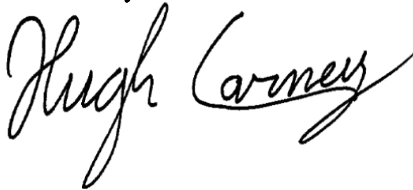
The Market Risk Ratings Proposal fails to provide an adequate basis for a comprehensive rulemaking. As drafted, the Market Risk Ratings Proposal appears to misalign risk and capital requirements severely for many securitization positions. Moreover, ABA is concerned that the

[8] Please see ABA letter dated October 18, 2011, Supervisory Treatment of Exposures to Investment Funds as Securitization Exposures. Available at http://www.aba.com/NR/rdonlyres/DC65CE12-B1C7-11D4-AB4A-00508B95258D/73904/ABALetteronInvestmentFundsasSecuritizations111019.pdf

Market Risk Ratings Proposal would likely predetermine future proposals to revise the General Capital Rules. As such, ABA urges the Agencies to re-propose the Market Risk Ratings Proposal concurrently with the proposal for the General Capital Rules.

Should you have any questions please feel free to contact the undersigned at (202) 663-5324. Thank you for considering these comments.

Sincerely,



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