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November 9, 2010

Comments Submitted Pursuant to the Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies

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Thank you for the opportunity to provide comments on the advance notice of proposed rulemaking ("ANPR") of the federal banking agencies ("Agencies") to modify their risk-based capital regulations to remove references to credit ratings and substitute other standards of creditworthiness, as mandated by Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") expressed in 75 Fed. Reg. 52283 (Aug. 25, 2010).

Still Considering all Ratings Equally

One problem that I see with the approach evidenced in the ANPR is that the associated regulatory agencies are still considering all ratings equally. There is no singular need for such an approach and, in my opinion; such an approach misses the regulatory arbitrage and ratings inflation that caused the crisis.

Moreover, such an approach will result in a substantial amount of "throwing the baby out with the bath water," in that it dismisses the favorable record in the ratings industry toward evaluations of long-established products, which are still performing admirably through the cycle. While we have known since the research of Richard Cantor and Frank Packer (1996) that ratings on securitizations have been inflated, that did not generalize to other product categories. Hence, there is no need to penalize ratings on long-established products for the problems recently experienced with securitizations.

The chief obstacle to an approach recognizes the difference comes down to the need to distinguish between well-established ratings on plain-vanilla products and new ratings on innovative products. Once that is accomplished, however, it becomes a relatively simple matter

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to maintain ratings as an analytical tool, where appropriate, and then look more skeptically upon ratings on newly developed product categories.

In fact, it is not hard to derive a mechanism for recognizing the difference between the two and defending the well-established plain-vanilla realm from incursion by regulatory arbitrageurs. In mid-2008, working with Sean Mathis, and Julia Whitehead, I helped to describe the bases for such a regulatory process, which could be used to distinguish between sound and unsound ratings and maintain the benefits of ratings as a regulatory input, while minimizing the propensity for regulatory arbitrage and ratings inflation.

Mason, Mathis, and Whitehead (MMW) are of the opinion that the subprime/credit bubble could never have grown so big so fast without access to easy money raised through securitization. That securitization, in turn, was fueled by the unbridled readiness of credit rating agencies to award investment grade labels on deeply flawed structured finance instruments. We see the source of the problem being the regulatory construct that initially established the rating agency Nationally Recognized Statistical Rating Organization (NRSRO) framework.

The root of the problem lies in the concept of an NRSRO created in 1975 to identify large, national, established rating agencies whose ratings could be used to help the SEC set capital requirements for broker-dealers.

Fundamental to the establishment of this scheme was the SEC's belief that AAA meant safe and liquid, an understandable assumption since, at the time, ratings were primarily used for corporate, municipal and government securities and those carrying the AAA label generally exhibited such characteristics. Two parallel trends caused that construct to break down:

- First, during the three decades since the establishment of the NRSRO construct, innumerable domestic and global financial regulations, investment mandates, and statutory requirements piggybacked on the SEC's use of NRSROs to differentiate securities that were safe and liquid from those that were not. Soon after the SEC used NRSRO rating for broker-dealer capital requirements, ERISA laid special importance on NRSRO ratings for public pension fund investments, a practice followed shortly thereafter by most public pension plans nationwide. Then, bank regulators began relying on ratings to determine safe and sound investments, and plan to expand the use of ratings internationally in the Basel II round of banking supervision.
- Second, asset-backed securities emerged as a significant investment category. Moreover, the simply-structured, homogenously-collateralized, and strongly-underwritten asset-backed securities of the 1980s and 1990s were easily absorbed into the NRSRO ratings scheme and, indeed, most of these securities performed as their ratings would have suggested. As we all now know, the asset-backed securities of the last few years were something very different - characterized by exceedingly complex structures, widely different new and exotic collateral, and untested models and assumptions, which presented a recipe for highly unreliable ratings.

The confluence of these trends was that fiduciaries and financial institutions that were supposed to remain safe and sound in the public interest poured money into instruments whose performance would prove disastrous. Hence, the impact of inflated credit ratings is vast,

extending from pension funds whose ability to meet obligations is deeply impaired to municipalities who struggle for cash to meet expenses to money market funds who proved to be less than a safe haven for investors' short term funds to bank balance sheets which have been dramatically weakened by losses and an inability to liquefy assets.

Of course, the main purpose of the ANPR before us is to constrain the use of ratings by those myriad agencies in a vast web of regulations and rules. But in acting in a broad-brush fashion, were are losing sight of the fact that the approach worked well for conventional corporate obligations, sovereigns, and other established debt sectors, even if it never effectively addressed the more complex surveillance demands of newer financial products.

It is important to note, however, that there is no evidence that the mere presence of a rating was ever intended to make *all* financial products eligible for ratings acceptable under those myriad regulations. In fact, there is evidence that such treatment was not intended. Even in the most recent legislation, the Credit Improvement Act of 2006, a multitude of synthetic structures were purposefully omitted from NRSRO rating because it was felt that they were too new to be rated (even though bank regulators were already allowing those products to be used to lower bank capital requirements).

It is important to note that NRSRO credit ratings were not supposed to be applied to ANY AND ALL financial instruments. Most recently, the Credit Rating Agency Reform Act of 2006 requires NRSRO applicants to register for defined categories of issuances and the definition of asset-backed securities referenced in CFR 17, section 224, para 1101(c), plainly excludes synthetic CDOs and ABS. However, while 1101(c) clearly demonstrates a regulatory sensitivity to the risks of newer asset-backed classes, it failed to prevent the current crisis for two reasons: first, synthetic asset-backeds which were awarded ratings by credit rating agencies who were registered as NRSROs may have been treated, for all intents and purposes, as NRSRO securities by investors and institutions required to rely on NRSRO pronouncements and notwithstanding the 1101(c) exclusion. Second, the 1101(c) definition was developed before it became clear that innovations within asset-backed collateral asset classes, such as mortgages, could cause just as much unpredictability as entirely new types of asset-backed securities, such as synthetics. Hence, new iterations of subprime and alt-a mortgages that had no performance history on which ratings could be reliably issued were able to creep in under the umbrella established by 1101(c).

Had the SEC anticipated the problems created by other asset-backed securities, in particular those characterized by exceedingly complex structures, widely different new and exotic collateral, and untested models and assumptions, which presented a recipe for highly unreliable ratings, it is reasonable to believe that the SEC would have excluded those, as well.

Recognizing that the use of NRSRO ratings is deeply embedded at all levels of the international financial system, discontinuing their regulatory use is not practical. However, if ratings are to be used for regulatory purposes, they must meet the test of reliability, which means that the instruments to which they are applied must also demonstrate adequate predictability. Clearly, then, new financial products need to demonstrate a history of performance before they can be deemed acceptable for NRSRO ratings. The proposed approach requires a regulatory agency to clarify the limitations on the types of investments for which ratings are meaningful, most

specifically with respect to asset-backed securities, and set out a process by which new innovative financial products can eventually, after exhibiting a reasonable record of historical performance, achieve similar status.

It should be noted that nothing should prevent ratings agencies from privately assigning ratings to non- approved financial products and such activity should be encouraged to foster financial innovation. Those ratings can be awarded on whatever basis and whatever scales the ratings agencies deem prudent and the market finds acceptable. However, those ratings should and will not in any way be confused with NRSRO ratings, which are the only ratings assigned meaning and importance in the laws and regulations of the United States of America.

In summary, first and foremost, regulatory policy needs to regulate the meaning of acceptable credit ratings that the government uses for its own regulations and legislation. That can be achieved by preventing untested asset-backed securities from being confused with stable, predictable, mainstream investments. If such regulation had been in place five years ago, the subprime bubble would likely never have occurred, since NRSRO-constrained investors would not have been able to buy the subprime securities that have caused the credit crisis.

Second, such a regulatory policy can stabilize asset-backed securities markets by providing a meaningful benchmark for the vast majority of asset-backed securities that have reliable performance. A substantial reason that credit markets are currently faltering is that lenders can no longer securitize loans as they did previously -- nor should they. But standard mortgages, credit cards, auto loans, and student loans were not the problem. Those markets are shut largely because the meaning of AAA and other bond ratings applied to structured finance securities have been so perverted that investors thinking of buying those securities have little idea to what loss level they would be exposing themselves. When investors regain confidence in the underlying bond ratings, markets for consumer finance will again open for business, public pension funds can invest with confidence, and citizens can once again be confident in the values of their homes and their pension funds.

Third, such a policy can provide a stable path for financial innovation, by allowing instruments to become NRSRO-eligible after they exhibit some degree of appropriate performance predictability. Only after that product “maturity” has been attained will the investment be able to be used to fund crucial consumer debt in safe and sound consumer banks. Providing that stable path for innovation, however, will also require acknowledging that markets have recently strayed from that path in recent years. Clearly, there may be a need to allow investors to hold what will now be considered “ineligible” securities already in existence until losses can be properly accounted for of the securities can be disposed on in an orderly fashion. Neither such provisions, nor the clarifications introduced by this bill, change the complexion of the ineligible securities; rather they merely acknowledge that such instruments were never what they were represented to be in the first place.

In summary, a sound regulatory approach toward distinguishing different types of ratings can allow investors to focus their concerns on their investments that fall outside of the new eligibility definition rather than the rest of the asset-backed securities market, which can then operate on a stable foundation of meaningful and reliable ratings. Such an approach will preserve community

banks' use of ratings where they are investing in relatively established product categories, while focusing on the problem of new risky applications elsewhere in financial markets.

Know and Use the most Sophisticated Risk Measurement Tools in the Marketplace

Of course, even the above approach does not deal with the problem of evaluating non-rated credit exposures or establishing reasonable risk-weights on a sensible basis. One key problem with any such approach is data. In my opinion, the regulatory agencies, themselves, are not ready to pay and provide training for the technical databases that can help make such sensible determinations.

Take, for example, securitization data on Intex. Adequate data and capabilities exist on the system to determine the first-loss point in any securitization, which could be used to calibrate sensible regulatory risk weighting. Moreover, such a calibration method would recognize, for instance, when a subordinate bond turbo-amortized, to investors' advantage, or credit enhancement stepped down, to investors' disadvantage. Both would affect risk weights in a dynamic fashion and the system exists to calibrate the approach. The problem is that the entry fee for the basic load starts at around $300,000.

Previously, I proposed that great economies could be achieved by requiring producers of data resources on products affecting regulated financial institutions to give the regulators a single free subscription. The marginal (additional) cost to the data providers would be slight, and the regulatory gains from doing so huge. Even just allowing the regulatory agencies to contract with a single subscription, rather than fifteen (for the Federal Reserve Banks, the Board, the FDIC, and the OCC) would yield an astonishing cost savings.

Still, no one is discussing such an approach. Instead, we seem to be considering developing another ad hoc static approach that will only be adjusted in response to the next crisis, rather than properly evolving as financial markets inexorably develop. The sound approach is expensive, but regulation with second-rate models and surveillance is bound to be ineffective. You cannot expect to alleviate regulatory capital arbitrage unless you stay on top of industry developments.

Adequately Capture Dynamic Adjustments to Risk and Capitalize them Through the Cycle

Even a sound process of risk weighting and initial capitalization will miss movements in credit risk through business cycles. With all the discussion of preemptive capitalization, it makes sense therefore to revise risk weights periodically to accommodate slower-moving developments in financial markets and the economy (faster moving developments need to be addressed through more flexible and finer means, like discount window policy, generally).

Even more fundamentally, securitizations are designed specifically to evolve their structures through their lifetime, stepping down credit enhancement and defeasing on schedules created at the initiation of the structure. My research with Eric Higgins and Adi Mordel is showing that throughout the history of securitization markets, credit enhancement sstepdowns are a key risk factor that should be captured in regulatory approaches. Obversely, subordinate securities may turbo amortize, at which time the move from the bottom of the waterfall to the top, requiring less

risk weighting. It is not hard to capitalize those dynamics appropriately, however, as they are coded in INTEX and freely available to users of that product.

Corporates evolve similarly as issues season, and as equity betas converge to one across the long term. RiskMetrics can be used, therefore, to similarly calibrate risk weights for seasoned corporates through their lifetime.

Sovereigns and other types of loans and bonds evolve similarly. For many of those products, single name and issuer CDS prices can be used to calibrate the decrease in risk weights that can benefit stable issuers moving toward maturity.

Of course, CDS have been vilified in the recent crisis as somehow "causing" overshooting in risk pricing. In fact, it is the lack of information endemic in today's markets that is the chief culprit. But that hasn't stopped may policymakers from blaming the messenger. We have to resist that temptation going forward and look hard at what the market is trying to tell us, even if we don't like what it is saying.

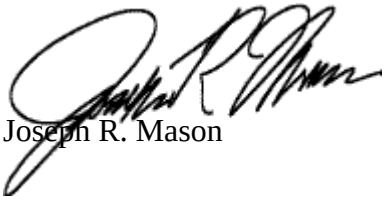
It is not Clear that Conflicts of Interest in Ratings are Solely or Primarily the Result of the "Issuer Pays" Model

While many researchers less familiar with credit ratings are tempted to blame issuer pays" conflicts of interest for the ratings inflation associated with the crisis, it is important to remember that the ultimate investor NEVER pays. As my attached paper with Charles Calomiris points out, it is conflicts of interest in a multi-layer relationship that create inflated and bad ratings when intermediary investors (institutional investors or pension funds) use ratings as a plausible deniability mechanism.

Until we address that fundamental problem that intermediate investors are just as – or even more – conflicted as issuers, we will not address the real problems in credit ratings and will create new problems in corporate governance ratings.

Hence, the effort before us needs to be viewed as a means of forcing those intermediaries to justify not only credit choices, but also as a parallel evolving issue corporate governance ratings, through more than inflated (credit) rating and even more problematic, bad (corporate governance) rating models. Regulatory rules that allow ratings to play a partial, rather than a complete, justification for investments can help preserve the historical benefits that ratings have contributed to markets while forestalling inflation and other perverse effects that have contributed to the downturn.

Respectfully Submitted,



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