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Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
E-mail: regs.comments@occ.treas.gov
Docket Number: OCC-2010-0016

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
E-mail: comments@fdic.gov
RIN Number: 3064-AD62

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20051
E-mail: regs.comments@federalreserve.gov
RIN Number: 7100-AD53

Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Internet: www.regulations.gov
Attention: OTS-2010-0027

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

Dear Sir/Madam:

State Street Corporation ("State Street") appreciates the opportunity to comment on the Advanced Notice of Proposed Rulemaking ("ANPR") issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision ("the agencies") on alternatives to the use of credit ratings in risk-based capital guidelines.

Headquartered in Boston, Massachusetts, State Street specializes in providing financial services to institutional investors, including investment servicing, investment management and investment research and trading. With $20.2 trillion in assets under custody and administration, as well as $1.9 trillion in assets under management, we operate in 25 countries and in more than 100 markets worldwide.[1] State Street is

[1] As of September 30, 2010.

organized as a financial holding company, with operations conducted through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company. Our perspective in respect of the ANPR is largely informed by our status as a Basel II "advanced bank" and as a significant investor in securitized assets.

State Street notes with interest the outcome of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which requires the agencies to identify and remove all references to or reliance on credit ratings in risk-based capital guidelines. From our experience, credit ratings can play a useful complementary role in the assessment of credit worthiness, particularly in the context of more traditional investment products, such as corporate, sovereign and municipal debt. We also note their importance in the context of collateral and other financial guarantees that play an essential role in the mitigation of risk within the financial system. As such, the full elimination of credit ratings from risk-based capital guidelines may not represent the most effective or efficient course of action.

Still, and consistent with Congressional intent, we agree that it is important for banking institutions to reduce their reliance on external credit ratings, and also to enhance their ability to independently assess credit risk. We therefore support the agencies' efforts to broadly consult on potential alternative approaches. This is particularly true in the case of securitized assets, where the use of credit ratings is now widely understood to have been inadequate, and to have resulted in an inaccurate assessment of underlying economic risk. Section 939A of the Dodd-Frank Act may thus provide an opportunity to incorporate a more risk-sensitive approach in the treatment of securitized assets.

Accordingly, our comments in respect of this ANPR focus primarily on the development of alternative methodologies for the evaluation of risk in securitized assets, with an emphasis on processes that correspond with existing industry practice, which best reflects projected loss experience over time, and which can be implemented across the spectrum of U.S. banking institutions.

Introductory Observations

State Street agrees that the principles identified by the agencies within section III a. of the ANPR are an appropriate basis for determining the suitability of alternative standards of credit worthiness in risk-based capital guidelines. In addition, we recommend that the agencies also emphasize standards which promote consistency of capital, including the avoidance of abrupt downgrades in credit worthiness. As demonstrated by industry experience during the financial crisis, the "cliff effect" inherent in the existing credit ratings-based approach is substantial and can result in significant market instability.

Notwithstanding legislative preference for a uniform standard of credit worthiness, we believe that broad differences in the size and sophistication of U.S. banking institutions may require the implementation of two complementary approaches. More specifically, we recommend the use of an advanced approach for certain larger, more complex financial institutions, and a more simplified approach for use by the majority of U.S. banks.

This is consistent with the agencies' framework for the implementation of Basel II, where advanced approaches for assessing and quantifying credit risk require financial institutions to develop their own methodologies with respect to critical risk parameters, such as probability of default, loss given default and exposure at default. Although not credit related, Basel II also requires advanced banks to develop their own measures for assessing operational risk. Accordingly, there is substantial precedence for the use, by certain larger, more complex institutions, of bank-developed models. As such, the implementation of a dual framework for the assessment of credit worthiness is likely to facilitate industry acceptance, and therefore compliance.

State Street believes that it is important for the agencies to develop alternatives to the use of credit ratings which build on the considerable progress made by the banking industry in strengthening the assessment and management of credit risk. We therefore do not support a return to pre-Basel risk-insensitive processes, such as the use of general risk exposure buckets. In addition, we believe that it is important to avoid approaches which are unnecessarily dependent upon market-based factors, given their capacity to diverge from actual economic risk and also their ability to precipitate additional instability. As such, we also do not support the use of credit default spreads and other similar measures in the assessment of regulatory capital.

In our view, third-party service providers can be an important source of value-added information in the assessment of credit risk. We therefore broadly support their use as part of the development of alternative standards of credit worthiness. We note in this respect, the attractiveness of the approach developed by the National Association of Insurance Commissioners, which relies on third-party analytics to determine risk-based capital requirements for certain asset-backed securities.

Securitization Exposure

In response to the agencies' request, we have considered the various alternative approaches to the use of credit ratings for securitized assets as described within section III c.v. of the ANPR. This includes the several methodologies which rely on the assessment of subordination within the capital structure, namely the gross-up treatment, the seniority regime and the concentration ratio approach. Although we agree that subordination is an important component of securitization risk, we do not believe that these various alternatives are suitable for the measurement of risk-based capital for the following reasons.

First, since these approaches rely solely on structural parameters, they ignore both expected and actual performance over time. They are therefore relatively inflexible and do not readily accommodate periods of market dislocation. Second, these approaches tend to over-simply risk, thereby either overstating or understating required capital.

Finally, these approaches do not require or even provide incentives for banks to fully understand the risks inherent in their investment assets. As such, they may lead to unwarranted moral hazard and create the potential for capital arbitrage, which was a significant issue early in the development of the regulatory capital framework for asset securitizations.

Conversely, we believe that a more simplified version of the Supervisory Formula Approach could prove attractive as an alternative measurement of credit worthiness. This would, however, require the further standardization of data elements, a more streamlined application process and the ability to rely on third-party service providers for the required analytics.

Advanced Approaches

In view of both the complexity of securitized assets and the need to promote sound risk management processes, we recommend that the agencies permit the use of advanced approaches for the estimation of risk-based capital for securitized assets, based upon the assessment of security-specific cash flows. This approach is widely used by financial institutions with advanced risk management capabilities to assess portfolio risk, including in the context of Pillar 2 economic capital ("ECap"). As such, with appropriate adjustments, these methodologies can be readily adopted by larger, more complex banking institutions to meet their Pillar 1 risk-based capital requirements.

In our view, there are two suitable alternatives for the measurement of security-specific cash flows. The first, the cash flow analysis method, relies upon the use of stressed macroeconomic scenarios and enables the derivation of a security-specific capital charge. The second, the loss coverage ratio multiple method, is similar to the Internal Assessment Approach, and relies upon the use of expected macroeconomic scenarios, as well as pre-defined capital risk weights. These two alternatives are described in greater detail below.

Advanced Approach - Cash Flow Analysis Method

The cash flow analysis method is a scenario-driven approach that combines the assessment of stressed macroeconomic variables with security-specific variables in order to determine projected collateral performance over time. This is then compared with available collateral and other structural characteristics in order to determine anticipated losses on a security-specific basis, and therefore required risk-based capital.

The cash flow analysis method is granular and includes a detailed assessment of both static and dynamic security-specific features, such as bond structure, available credit enhancements and issuer underwriting standards. Also considered are stressed macroeconomic variables, such as house price trends, unemployment rates and gross domestic product. Collateral performance is in turn measured by a number of core variables such as pre-payment history, loan-level defaults and loss severity vectors.

The cash flow analysis method requires significant analytical inputs, which sophisticated banks may develop internally. Alternatively, there are a number of third-party vendors, many with asset management backgrounds, which have the necessary expertise. From our experience, third-party vendors are a particularly attractive alternative given their ability to centralize both required data and analytics, and also ensure the development over time of appropriate industry best practices.

There are a number of advantages to the use of cash flow analysis in the assessment of risk-based capital. First, given the incorporation of macroeconomic projections, this approach encourages the analysis of risk drivers beyond the assets that support the securitization exposure. Second, the required macroeconomic inputs can readily be disclosed or even prescribed by the regulatory community, thereby promoting transparency and comparability across banking institutions. Third, macroeconomic assumptions used as part of the regulatory capital process can be connected to other bank-specific stress testing activities, thereby encouraging the integration of risk management processes on an enterprise-wide basis.

Advanced Approach - Loss Coverage Ratio Method

While we believe that the cash flow analysis method offers the greatest risk sensitivity in the calculation of risk-based capital, we recognize that there are concerns regarding the extent of industry reliance on internal model-based approaches. Alternatively therefore, we recommend that the agencies consider the development of a framework based upon the assessment of the loss coverage ratio, or the amount of collateral available with respect to a security to cover anticipated future losses.

In this methodology, expected cash flows in a securitization exposure are compared with available collateral to determine projected loss, or the amount of the collateral pool likely to be lost due to obligor default, and break even loss, or the amount of the collateral pool that can be lost before the occurrence of any loss of principal. It is the ratio of break-even loss to projected loss which determines the amount of collateral available to absorb expected losses, and hence the credit risk inherent in the exposure.

The structure of a security is an important component of the loss coverage ratio method and includes an assessment of variables such as level of subordination, the level of over-collateralization, available cash reserves and excess yield. So as to ensure appropriate risk-sensitivity, the assessment of the loss coverage ratio is also informed by a number of performance-based factors such as default rates, prepayment rates and collateral loss severity.

Since this approach is based upon the calculation of a defined security-specific metric, it has the advantage of being transparent and subject to independent validation. As such, it is replicable across financial institutions and with certain adjustments can be used as the basis for both an advanced and a more simplified assessment of securitization risk.

Simplified Approach – Loss Coverage Ratio Method

While considerable security-specific inputs are required to derive the loss coverage ratio, this information is readily available from independent sources. As such, we recommend that the agencies develop in parallel a more simplified methodology for use by the majority of U.S. banks. More specifically, we believe that it would be appropriate to develop a standardized framework in which smaller banking institutions would be able to rely on supervisory-approved third-party modelers and/or supervisory inputs to obtain the loss coverage ratio on assets held.

Among the advantages of the loss coverage ratio method is that it may provide greater opportunity for regulatory input in risk-based capital, through the application of risk weights to different coverage multiples. This would result in a "look-up table" format similar to the current ratings-based approach. Expected macroeconomic assumptions could also be supplied by regulators, either to institutions permitted to use the advanced approach or to designated third-party providers, thereby resulting in a more granular yet consistent assessment of risk.

As demonstrated by the financial crisis, as well as industry experience with economic capital models, decisions regarding model calibration are crucial to the accurate assessment of risk. This is particularly true with respect to securitized assets, where there is the clear potential for both the understatement and overstatement of credit risk. We note in this respect the particular risk of a precipitous "cliff effect" such as experienced during the financial crisis, when credit ratings changed suddenly and by multiple notches, resulting in a substantial widening of credit spreads and a reduction in crucial market liquidity. As such, we encourage the development of risk weights that closely correspond with actual industry loss experience over time, including during the recent financial crisis. Such risk weights should be appropriately graduated to avoid volatility in capital requirements, in excess of loss expectations.

Thank you once again for the opportunity to comment on the important matters raised within this ANPR. To summarize, State Street supports the use of alternative measures of credit worthiness when assessing a bank's exposure to securitized assets, and believes that differences in the size and complexity of institutions in the U.S. can best be addressed via the development of both an advanced internal model-based approach and a more simplified standardized approach.

The most risk-sensitive and therefore effective basis upon which to structure the advanced approach is through the use of the cash flow analysis method. Alternatively, the agencies could create a framework based on the measurement of the loss coverage ratio, which would then be converted into regulatory capital based upon supervisory specified risk weights.

Whereas smaller banking institutions using the simplified approach would be permitted to utilize third-party vendors when determining the loss coverage ratio, larger, more complex institutions would be required to rely on their own internal credit risk management framework, in a manner consistent with the prevailing Basel risk-based approach.

Please feel free to contact me at smgavell@statestreet.com should you wish to discuss State Street's submission in greater detail.

Sincerely,

Stefan M. Gavell