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By Electronic Mail

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Re: Joint Advance Notice of Proposed Rulemaking on Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies, OCC (Docket ID: OCC-2010-0016); Board (Docket No. R-1391); FDIC (RIN 3064-AD62); OTS (Docket ID: OTS-2010-0027) (the "Release")

Moody's Investors Service ("**MIS**") appreciates the opportunity to provide comments to the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, "**the Agencies**") on the Release,[1] which was published in response to Section 939A of the Dodd-Frank Wall Street Reform

[1] Moody's Analytics ("**MA**") is submitting a separate comment letter to the Release. MIS and MA are two legally and operationally separate subsidiaries of Moody's Corporation ("**MCO**"). MIS is the credit rating agency and registered Nationally Recognized Statistical Rating Organization. MA brings together all of MCO's other commercial activities, including the provision of a range of analytical and technical products and services.

and Consumer Protection Act (the "**Act**"). Section 939A seeks to address the regulatory use of ratings, and Moody's supports its mandate. We also support the healthy dialogue the Agencies have facilitated through their Release, which describes the areas in the Agencies' general risk-based capital rules, market risk rules, and advanced approaches rules where the Agencies rely on credit ratings, as well as the Basel Committee on Banking Supervision's recent amendments to the Basel Accord and requests comment on potential alternatives to the use of credit ratings.

Historically, MIS has supported discontinuing the use of ratings of nationally recognized statistical ratings organizations ("**NRSROs**") in regulation.[2] We continue to hold this view. We recognize, however, that in light of market conditions, eliminating or reducing NRSRO ratings-based criteria should be pursued judiciously to avoid further disruption in the already fragile financial system. Consequently, we encourage the Agencies to analyze carefully the potential direct and indirect impact of the use, reduction or elimination of ratings on market participants and financial markets.

As we will discuss below, we believe that mechanical triggers, regardless of whether they are ratings based, based on market signals or otherwise, can inadvertently harm markets by amplifying rather than dampening the risks in the system. Specifically, automatic triggers can cause involuntary and mandatory reactions, such as augmenting capital cushions or divesting of exposures, with little room for discretion to consider more tempered responses. As such, while we support the Agencies' inquiry into over-reliance on ratings in regulation, we caution that risks to market safety and stability will remain so long as any alternative measuring system is used to trigger overly mechanistic responses.

In this vein, we believe that there are two competing interests that must be balanced against one another. On the one hand, the regulatory system must provide a calibration tool to the various entities that is simple to use and access, so that it can be implemented with little cost and in a consistent and uniform manner. On the other hand, such a tool may expose the system to dramatic swings. We believe the solution lies in *modifying* the use of the measurement tools rather than simply *substituting* one tool for another. Specifically, a single measurement system or a range of alternatives – whether ratings based or otherwise – should not be used to trigger a mandatory and mechanistic response, but rather as a tool for prudential oversight that allows for more flexible and tempered responses than is often the case today.

As we discuss in greater detail below, we offer three suggestions for the Agencies' consideration. First, we encourage the Agencies (and other regulatory bodies) to consider the extent to which risks to market safety and stability derive from the simple existence of ratings in regulation versus how ratings are being used by regulation. Second, if the Agencies decide to replace ratings with an alternative measurement tool, we suggest that their use be designed to avoid automatic

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[2] See, e.g., *Moody's Comment Letter re Proposed Rule on Asset-Backed Securities – File S7-21-04* (July 12, 2004), *Moody's Comment Letter re References to Ratings of Nationally Recognized Statistical Rating Organizations – Files S7-17-08, S7-18-08 and S7-19-08* (Sept. 5, 2008); *Moody's Comment Letter re Money Market Fund Reform – File S7-11-09* (Sept. 8, 2009); *Moody's Comment Letter re Proposed Amendments to Regulation AB – File S7-08-10* (August 31, 2010).

triggers. Third, we recommend that the Agencies allow for a range of tools to be used by banks to set capital requirements, in effect extending the use of the internal ratings approach from those originally anticipated by Basel II to small regional banks. Such an approach allows for a certain amount of discretion in the oversight regime so that regulated entities and regulators can take more measured and particularized steps if and when necessary.

We have refrained from commenting on any specific alternative because we believe other market participants, such as financial institutions, are in a better position to judge whether these criteria are appropriate to meet the Agencies' objectives and the Act's requirements.

I. Reducing Mandatory Use of Ratings

Consistent with our historic views about the regulatory use of credit ratings, we continue to believe that ratings-based criteria in regulation should be reduced and overtime discontinued. There are three primary reasons for our perspective.

First, credit ratings should not be positioned as the sole arbiters of credit risk.

While MIS's credit ratings have had a strong historical track record in differentiating credit risk, we continue to believe that they should not be used as a triggering mechanism with automatic and mandatory repercussions – e.g., mechanically adding or reducing capital cushions due to ratings upgrades or downgrades. Credit rating agencies ("**CRAs**") provide forward-looking opinions and research about credit risk, and serve a valuable role in the financial markets because they provide a point of reference that is easily understood by market participants. These participants assess the opinions put forth by CRAs relative to their own credit judgments, thus taking positions that agree or disagree with CRAs. In this regard, MIS's credit ratings are important because they promote dialogue and debate among market participants, which in turn help further the integrity of the debt markets and understanding of credit risk. In short, CRAs are important in the markets because they have proven to be authoritative credit market commentators. However, CRAs' should not be construed as the sole arbiters of credit risk.

Second, credit ratings should not be used to measure any risk other than credit risk.

MIS's credit ratings are our current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities and are a useful gauge of future creditworthiness. They do not measure any other risk, and as such should not be used as a proxy for assessing other characteristics of a security, such as liquidity risk, price volatility or marketability. Credit ratings should not be used as a proxy for measuring anything other than what they are intended to measure, credit risk.

Third, official recognition and use of ratings may lead to distortions in the CRA industry.

We believe that widespread incorporation of ratings into regulation can affect the way ratings are used by regulated entities, the bases upon which issuers choose CRAs and the ways CRAs compete with each other. The appropriation of ratings for regulatory purposes also risks legislative or regulatory intrusion into the content of ratings, as the authorities' interest in comparable ratings can pressure CRAs to produce homogenous opinions and undermine their ability to provide diverse,

independent opinions. Moreover, directly and solely incorporating credit ratings into the oversight regime of other regulated entities creates incentives for market participants to over-emphasize the opinions of CRAs instead of conducting their own credit analysis.[3]

Accordingly, MIS supports initiatives to encourage market participants and regulators to consider carefully whether and, most importantly, how ratings should be used.

II. Principles That Should Guide the Formulation of Creditworthiness Standard

Question (1) seeks comment on the appropriate objectives that should be used in considering alternative measures of credit-worthiness. We support the Agencies' approach of considering overarching principles that should guide the formulation of creditworthiness standards and suggest that the following concepts be considered:

1) A single measurement system may increase rather than dampen systemic risks.

   In our view, a single measure may increase rather than reduce systemic risk. While we appreciate that a single measurement tool has the advantage of providing a consistently implemented approach across the banking system, thereby limiting regulatory arbitrage and moral hazard, we caution that it also can expose the system to uniform movements. Specifically, any one measure can cause all relevant institutions to behave in a similar fashion at the same time, which in turn could amplify the importance and ramifications of that single measure.

2) Simple measures may misconstrue some of the complexities of the market.

   MIS recognizes that there are benefits from identifying and using objective, widely accepted standards for financial markets because this can facilitate efficient regulation. Credit ratings can be useful in this regard because they are easy-to-use, broadly disseminated, independent and reliably predictive opinions about relative creditworthiness. However, we caution the Agencies that providing one simple to use tool could create a "tick-box" culture. In the end, unless market participants are encouraged to conduct their own analysis and to use a plethora of tools in arriving at their views, the result may be less well-informed, and therefore, less disciplined markets.

3) Provide a more clearly defined time horizon.

   As the Agencies are aware, different credit risk measures can assess credit risk under different time horizons. For the purposes of identifying tools to help financial institutions maintain sufficient capital cushions, we would suggest the Agencies consider more clear guidelines on time horizons.

[3] For a more detailed discussion, please see our comments to the Securities and Exchange Commission as referenced in footnote 2.

III. Suggestions for the Agencies' Consideration

As noted earlier, we realize that a whole-sale elimination of ratings from regulation may cause more disruption in already fragile markets. To that end, we suggest that the Agencies consider not only what measurement tools regulated entities use for calibrating risk, but also how these tools are used. Specifically, we provide three recommendations to the Agencies that we believe would reduce the likelihood that ratings or any other credit risk measure used in regulation could prove destabilizing.

First, we recommend that the Agencies may want to consider retaining ratings in certain regulations, if no suitable substitute can be found, but modify their use, if necessary, to avoid triggering significant market events when ratings change. This can be done by, for example, (1) maintaining minimum ratings-based asset-purchase requirements but eliminating ratings-based asset-disposal requirements, or (2) continuing to consider ratings into capital requirements but varying their impact on required capital so that individual rating changes are less likely to have market-moving effects.

Second, if market-based signals or credit risk measures other than traditional ratings are chosen, we believe their use should also be tailored to avoid such triggers. In this regard, it is worth noting that the use of market-based tools are particularly vulnerable to destabilizing, feedback loops.

Third, rather than impose any specific recommendation on credit risk measures to its members, in our view, the Agencies should allow banks to use a range of credit risk tools that would appropriately provide signals (not triggers) of the need for closer scrutiny (not mandatory responses) by regulators or the banks, themselves. In effect, we are recommending that the internal ratings approach be extended to small banks. Under this approach, banks are free to select their own methods to calibrate risk. In so doing, they can use various third-party tools (including ratings) or design their own methodology. However, we believe it is essential that the bank: (1) provide to its regulator an analysis explaining the rationale for the methods or tools chosen; and (2) use these tools or methods in a consistent manner. This second requirement ensures that banks use the chosen methods or tools for both regulatory capital analysis and internal risk analysis, and that they do not "cherry pick" to, for example, reduce required capital.

In our view, using various types of tools and methods (including ratings) as part of a broader oversight structure provides several advantages. Most notably, it allows for discretion in the system at both the regulatory level and the regulated entity level so that more particularized and tempered decisions are made in overseeing various sectors. In addition, by encouraging a diversity of credit risk measures and modifying their use in the oversight regime, we believe regulators could ensure that no individual opinion or measure causes excessive market reaction. Finally, in our view, by not mandating mechanistic responses to any one particular measurement tool the perception of government bias would be eliminated, which in turn would open the market for credit risk analysis to greater competition.

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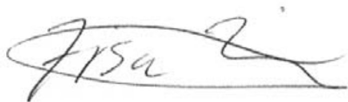
As stated earlier, we support the Agencies' inquiry into alternatives for the use of NRSRO ratings in the oversight regime of banks. However, we believe that using any single measure, whether ratings based or otherwise, as a triggering mechanism in regulation can amplify rather than dampen risk. We therefore caution against the potential of substituting the use of ratings with the use of another measurement tool. As noted in the Release, if ratings were replaced with a different third-party assessment of risk, undue reliance on ratings could simply shift to this third-party. We instead suggest that the Agencies allow for the use of a range of risk measurement tools and reconsider not only *what* these tools are, but *how* they are used. A variety of third-party opinions and models with differing benefits and tradeoffs can be useful in this regard. We defer to others in the market to provide the Agencies with their perspective on the various alternatives available.

We appreciate the opportunity to comment on the Release. We would be pleased to discuss our comments further with the Agencies or their staff.

Sincerely,



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