COMMITTEE ON CAPITAL MARKETS REGULATION

February 3, 2012

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Re: Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions, 76 Fed. Reg. 79,380 (OCC Docket ID OCC-2010-0003, OCC RIN 1557 – AC99; Fed Docket No. R-1401, Fed RIN 7100 – AD61; FDIC RIN 3064 – AD70).

Dear Mr. Walsh, Ms. Johnson, and Mr. Feldman:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the Office of the Comptroller of the Currency (OCC), Federal Reserve Board (Board), and Federal Deposit Insurance Corporation's (FDIC, together with the OCC and the Board, the "Agencies") amendment to their January 2011 notice of proposed rulemaking[1] on the market risk rules, regarding alternatives to credit ratings for debt and securitization positions[2] under § 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[3]

Since 2005, the Committee, composed of 32 members, has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains fifty-seven recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.[4] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

[1] Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890 (proposed Jan. 11, 2011).
[2] Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions, 76 Fed. Reg. 79, 380 (proposed Dec. 21, 2011) [hereinafter Proposed Rules].
[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 [hereinafter Dodd-Frank Act], § 939A.
[4] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), http://www.capmktsreg.org/research.html.

The Dodd-Frank Act requires that federal agencies remove and replace references to credit ratings from their regulations.[5] We recognize the complexity of this task and the potential conflict between the various objectives of the Proposed Rules. For example, the Agencies are seeking to develop a set of rules that are "sufficiently transparent, unbiased, replicable, and defined to allow banking organizations of varying size and complexity to arrive at the same assessment of creditworthiness", while also being "reasonably simple to implement" and not unduly burdensome on banking organizations,[6] particularly small banks that are not subject to the Basel guidelines and do not have extensive credit staff. At the same time, the Proposed Rules must be sophisticated enough to "appropriately distinguish the credit risk associated with a particular exposure within an asset class" and to "minimize opportunities for regulatory capital arbitrage."[7] Unfortunately, the Proposed Rules fall short in attempting to balance these factors and tend to favor simplicity and ease of application over the need for sophisticated measurement techniques that are sensitive to the characteristics and risks of the assets being weighted.

The Proposed Rules will result in increased capital requirements for domestic banks. We believe there should be quantitative support and a sound reason for these increases, which have the potential to curtail banks' trading in these assets, stifling liquidity in these markets. We note that if banks find the enhanced capital requirements too punitive to continue trading in these instruments, their decision may have the unintended effect of pushing these assets to other parts of the financial industry that are not subject to capital requirement rules. Furthermore, imposing onerous additional capital requirements on domestic banks will certainly hinder our domestic banks' ability to compete with their non-U.S. peers that currently operate under the Basel guidelines.

Specifically, we believe the Proposed Rules are not sufficiently sensitive to the risk of positions underlying securitizations. For example, with respect to securitizations, the Proposed Rules do not distinguish between securitizations based on prime pools versus sub-prime pools or government-guaranteed student loans versus private student loans. The Proposed Rules also do not account for credit enhancements (for example, over collateralization) that could mitigate the potential risk of the positions. Furthermore, the Proposed Rules do not provide a sufficiently granular approach towards risk weightings for different levels of seniority in a securitization. The simpler, more blunt methodology proposed certainly promotes ease of use, but fails to recognize the actual risk posed by the assets being held. In addition, because the Proposed Rules require the same amount of capital for underlying positions that pose varying levels of risks, banks may be incentivized to hold the riskier assets to achieve the maximum potential return for the same amount of capital.

We note the extensive efforts that the American Securitization Forum (ASF) the American Bankers Association (ABA), the Financial Services Roundtable (FSR), The Clearing House (TCH) and the Securities Industry and Financial Markets Association (SIFMA) have made to date in analyzing the effect of the Agencies' proposed methodologies on capital requirements for securitization positions. These groups have also highlighted a number of definitional shortcomings in the Proposed Rules, where further clarity from the Agencies is

[5] Dodd-Frank Act § 939A.
[6] Proposed Rules at 79,382.
[7] *Id*.

required. We would strongly encourage the Agencies to take into account the input of banking organizations that currently hold these positions, and in particular, the recommendations of ASF, ABA, FSR, TCH and SIFMA.

With respect to debt, we believe the Proposed Rules' reliance on the Organization for Economic Cooperation and Development's (OECD) country risk classifications (CRCs) is problematic. Despite the Agencies' statement that "The OECD is not subject to the sorts of conflicts of interest that affected NRSROs because the OECD is not a commercial entity that produces credit assessments for fee-paying clients, nor does it provide the sort of evaluative and analytical services as credit rating agencies",[8] the OECD is an intragovernmental body with its own political and economic agenda. The OECD's rating of sovereign debt is clearly inferior to the ratings of the NRSROs; the Agencies themselves acknowledge that "CRC classification may not accurately reflect a high income OECD country's relative risk of default."[9] The Proposed Rules attempt to address this concern by assigning a specific risk weighting factor to sovereign debt where the sovereign has defaulted in the previous five years;[10] however, even with such a measure, the resulting methodology is still inferior to the NRSRO rating system. The OECD itself acknowledges that its CRCs "are not sovereign risk classifications and should not, therefore, be compared with the sovereign risk classifications of private credit rating agencies".[11] Moreover, the OECD classification system began in 1999; with such a limited history, it is difficult to measure the correlation between probability of default and CRC rating over time.[12]

We recognize that the proposed alternatives presented by the Agencies (credit default swap spreads or bond spreads) pose their own complexities (for example, they could be extremely volatile and would require the development of an averaging or smoothing mechanism to be included in the weighting methodology). However, we strongly believe these alternatives are worth pursuing. Finally, should none of these alternatives be viable, we would encourage Congress to amend § 939A of the Dodd-Frank Act to allow credit ratings to be used for sovereign debt where influence by the sovereign issuer is a very modest concern compared to the solution of allowing sovereigns that will be rated to develop their own methodology for doing so.

The Agencies have said they "strove…to establish capital requirements comparable to those published in the 2005 and 2009 revisions [to the Basel guidelines] to ensure international consistency and competitive equity."[13] Furthermore, "the agencies believe that the capital requirements under the proposed methodologies generally would be comparable to those produced by the [Basel Committee on Banking Supervision's] standardized measurement method."[14] However, the Agencies have not provided evidence to support this conclusion. We note the Agencies' statement that "At this time the OCC is unable to estimate the capital impact of this NPR with precision."[15] In addition, although the Proposed Rules relate only to guidelines

[8] Proposed Rules at 79,384.
[9] *Id*.
[10] *Id*. at 79,385.
[11] Org. for Econ. Cooperation & Dev., *Country Risk Classification* (Jan. 2012), http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_1,00.html.
[12] Adam Litke, Commentary, *Credit Risk Regulation Without Credit Ratings*, BLOOMBERG BRIEF (Bloomberg LP, New York, N.Y.), Jan. 18, 2012, at 5.
[13] Proposed Rules at 79,382.
[14] *Id*. at 79,383.
[15] *Id*. at 79,399.

for market risk, the Agencies intend to apply the creditworthiness standards for debt and securitizations from the Proposed Rule to their general risk-based capital rules at a future date.[16] We would strongly encourage the Agencies to conduct or commission a quantitative impact study on such an important and wide reaching rule.

Finally, we note that further cost-benefit analysis is critical in light of the ruling this past July by the U.S. Court of Appeals for the D.C. Circuit in *Bus. Roundtable v. Sec. and Exch. Comm'n*.[17] If the Proposed Rules are to withstand judicial scrutiny, robust analysis of the broader impact of these rules must be undertaken.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

R. Glenn Hubbard	John L. Thornton	Hal S. Scott
CO-CHAIR	CO-CHAIR	DIRECTOR

[16] *Id*. at 79,382.
[17] *Bus. Roundtable v. Sec. and Exch. Comm'n*, 647 F.3d 1148 (D.C. Cir. 2011).