Egan-Jones Ratings Company
Tel. 1-610-642-2411 segan@Egan-Jones.com

Providing timely, accurate credit ratings to Institutional Investors

Docket ID: FDIC 2011-0171

Comment on Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions

Dear Sirs:

Your efforts to address the failings of the rating firms are likely to cause significant harm to the country's financial system and ultimately result in massive taxpayer costs.

The credit crisis of 2008 and the developing European credit crisis of 2011/2012 were caused primarily by inflated ratings; securities which were rated and in turn priced at inflated levels and subsequently downgraded left leveraged institutions with severe capital shortfalls. Lehman Brothers shareholders' equity was merely 3% of total assets such that a slight decline in the value of assets eliminated capital. Many "AAA" assets priced at 100 cents on the dollar fell below 50 cents and institutions had to turn to the Federal government for support. This scenario is being played out in Europe whereby supposedly solid sovereign credits are far from solid and banks are scrambling to shore-up liquidity and cover losses. As a result of the credit crisis, faith in the ratings have been broken such that the critical marginal investors are being more careful and not relying on inflated ratings. The unfortunate upshot is that capital is not moving and many economies are stuck.

Regarding the FDIC's and OCC's proposals for National Bank Regulations that "banks must supplement the external ratings with due diligence processes and analyses that are appropriate for the bank's risk profile and for the size and complexity of the instrument" (see page 14 of the OCC's proposed rule). The major problem associated with internal analyses is that they have proven to fail miserably when needed most. Bear Stearns, Lehman Brothers, and CitiCorp prided themselves on their sophisticated credit analysis and risk management systems but were found lacking because of the massive bias in favor of their own holdings. Like LTCM (Long Term Capital Management) and the Reserve Fund, there was no independent assessment of the true credit quality.

Regarding the OCC's Guidance on Due Diligence Requirements in Determining Whether Investment Securities are Eligible for Investment (the appended Docket No. OCC-2011-0022), "Confirm spread to US Treasuries is consistent with bonds of similar credit quality" on page 9, such a requirement can easily be manipulated by speculators and facilitates the impoverishment of banks. Speculators or even the issuers of securities could simply buy up the available float and unload securities on unsuspecting banks. Likewise, the fact that a security has a high yield does not necessarily translate into poor credit quality. The impact of the proposed rule is likely to have a far more deleterious effect than the drafters envisioned; capital is likely to chase "popular" but flawed opportunities and deprive sound investments of needed capital.

Reliance on the OECD to determine credit quality is equally flawed and has been a major weakness to Basel II ratings where exposure to government securities of OECD states are allocated minimal or no capital charge regardless of underlying credit quality. Reliance on the OECD for ratings will hide the true credit quality from investors and provide a false sense of security.

In place of the OCC's rather nebulous guidelines for determining whether investment securities are eligible for investment, we propose that financial institutions conduct their own due diligence, but supplement their efforts with those of a credit analysis firm with the following characteristics:

Independent – does not receive payment from issuers either directly or indirectly,

Proven Success – has succeeded in providing timely, accurate ratings, and

Regulated – is subjected to SEC oversight to prevent front-running and other misdeeds.

Despite efforts to make ratings less important, they remain critical, as demonstrated by the recent controversy regarding the US's and EU country ratings. Major objectives of the FDIC and OCC should be the restoration of faith, the flow of capital and thereby facilitate the recovery of economies and creation of jobs. A rating firm cannot be independent if it is accepting compensation from the very issuers it is rating.

Very truly yours,

Sean J. Egan