Institutional Risk Analytics

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November 10, 2010

Comments Re: ANPR OCC–2010–0016
Office of the Comptroller of the Currency
250 E Street, SW., Mail Stop 2–3
Washington, DC 20219

Dear Sirs:

As per the request of Suzanne L. Clair, Senior Capital Markets Specialist, Federal Deposit Insurance Corporation ("FDIC") and preparatory to the "Credit-Worthiness Standards under the Dodd-Frank Act: A Roundtable Discussion" hosted by the Federal Reserve Board of Governors, the FDIC, and the Office of the Comptroller of the Currency at the Federal Reserve's main building in Washington, DC, on November 10, 2010, below follow our comments on ANPR OCC–2010–0016.

General Comments

- The most basic point to make is that the ratings regime adopted to replace the mandatory use of NRSROs should be dynamic, data driven and isolated from human and political manipulation. In terms of our perspective at IRA, we take a different approach to ratings than do many of the other organizations appearing at this roundtable. At IRA, our credit ratings are entirely mechanical and do not allow for human intervention in terms of the rating and/or the timing of the change in a rating. The inputs for our ratings are limited to the public disclosure of the obligor and do not include non-public information, contacts with management or other subjective inputs.

- In addition, our U.S. bank ratings are explicitly focused on safety and soundness as opposed to estimating probability of default ("P(D)") or Loss Given Default ("LGD"). The business cases needs for the users of our consumer rating service, the IRA Bank Stress Index ("BSI"), range from asset allocation for large depositors to vendors assessing the likelihood of failure of an insured depository. The ratings histories of all depositories which have failed during the current credit cycle are available on our web site. Our BSI ratings include factors for earnings, capital, credit defaults, exposure at default and efficiency, and thus cover both operational and financial risks (See Appendix A for examples of the most recent IRA BSI ratings sorted by bank units and total bank assets).

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- At the outset it needs to be stated that the mandates for change regarding credit rating agencies in the Dodd-Frank law are an outgrowth of the relatively recent involvement of some NRSROs in the *primary market* for creating complex RMBS and other types of structured securities. Many of these derivatives laced securities were sold as private placements and without SEC registration or other disclosure. These complex structured assets have been a significant source of loss to banking organizations, insurers and other investors.

- Generally speaking, the NRSROs and the broader ratings and analytics community have done a reasonably good job in assessing the credit risk of "plain vanilla," SEC registered corporate, municipal and RMBS/CMBS securities in the *secondary market* going back more than a century. The top agencies have done a less robust job on sovereign and financial names, largely owing to political pressures not to downgrade troubled financial institutions during times of macro-economic stress. The examples of Citibank in 1991 and Enron a decade later illustrate the danger of political manipulation of the NRSROs.

- The task of rating a security/exposure is also one of valuation. The question of assessing value is a function of assessing credit, liquidity and other factors, task which are supposed to be intrinsic to the role of banking organizations. Much of the "problem" facing investors, ratings agencies, advisors and regulators when it comes to credit ratings for products and especially complex structured assets stems from (1) flaws in market structure and disclosure, and (2) the willingness of banking organizations to rely upon third-party ratings to make investment and underwriting decisions.

- The financial ghetto known as "over-the-counter" or OTC is the source of much of the current financial crisis and the political desire for change regarding the role of the NRSROs. The growth of the OTC market runs directly contrary to what was once a census among U.S. policy makers regarding public, multilateral markets. Today we see a marketplace that is fragmented into a series of proprietary, bilateral OTC ghettos maintained by single dealers, situations that are analogous to investors trading unregistered paper in the doorways of buildings in lower Manhattan a century ago.

- The dealer community calls the bilateral OTC market configuration a vehicle for "innovation." The author Martin Mayer refers to the OTC derivatives market as a "bucket shop." To our conversation, the OTC market seems deliberately constructed to avoid transparency and to violate all of the lessons we learned in the Great Depression. Today the OTC markets for complex structured assets is a closed, predatory environment where legal standards such as suitability and know your customer are almost entirely ignored and disclosure is minimal. Most telling is the fact that other dealers will not trade much less make markets in the complex OTC products originated by other banking organizations

- Whereas the NRSROs, and literally hundreds of private ratings, analytics and Buy Side practitioners, are able to track the performance and valuation of corporate debt and plain vanilla RMBS/CMBS securities, in the world of complex structured assets the liquidity of the security and access to information on the deal structures are deliberately limited by the originating dealers. Even for SEC-registered deals, the uncertainty with respect to access to data and the models used to create these complex structured assets limits the ability of the markets to value and thus rate complex securities. If other banks and dealers will not value these "unique" assets, how can any third party agency possibly provide a credit rating?

- Given the existence of the OTC market ghetto, is there any question as to why we have a problem with ratings for these "innovative" securities? In classical terms, the business of ratings involves assessing expected cash flows and the ability of an obligor to meet those finite commitments. But in the world of OTC derivatives and complex structured assets, the performance of the security depends upon unpublished proprietary models and multiple factors few participants can assess. These models are so speculative and the event horizons they suggest so volatile that assigning a rating is so speculative as to render the output meaningless. As Benjamin Graham & David Dodd wrote in <u>Securities Analysis</u>, the more speculative the inputs, the less the analysis matters.

- The fundamental problems of transparency and liquidity in the OTC market present profound challenges to regulators, both in terms of assessing ratings as part of constructing risk-weighted values for different exposures and assessing the overall stability and capital adequacy of banking organizations. As discussed further below, the impact of OTC market structure on the credit ratings world is relevant to the ANPR and especially in the context of calculating risk-weighted exposures for insured depository institutions.

- Moreover, the concurrent rule making processes by the FDIC and Securities and Exchange Commission ("SEC") with respect to new rules for securitization should also be carefully assessed by the agencies responsible for this ANPR. The agencies also ought to explicitly take notice of the new rules being adopted in the EU (Rule 122a) whereby the purchaser of a security or complex structured asset will be penalized via higher capital charges for selecting any security where adequate disclosure is not present. In essence, the EU will penalize banks which cannot demonstrate that they know what they own.

Specific Comments

a. Creditworthiness Standards

Question 1: The agencies seek comment on the principles that should guide the formulation of creditworthiness standards. Do the principles provided above capture the appropriate elements of sound creditworthiness standards? How could the principles be strengthened?

The principles included in the ANPR are a good start. The agencies should consider strengthening them by creating a general stricture on the types of assets and/or exposures which an banking organization may purchase to those where (1) disclosure by the originator is sufficient for *the purchaser to replicate the valuation assumptions and scenarios employed by the issuer in selling the security* and (2) the banking organization, NRSROs and/or other agencies and advisors may thereby value/rate that security on an ongoing basis. We see no problem with banking organizations using third-party ratings to test and validate internal ratings, but consistent with Dodd-Frank, the internal ratings process must be the primary basis for making the investment decision.

Going back to the early proposals for Basle II, the banking organization ought to be required to demonstrate *to the satisfaction of supervisors*: (1) the ability to internally value and/or rate the security at the point of purchase and (2) to then use external ratings to test these results and validate the banking organization's internal forward ratings on an ongoing basis. Supervisors should, in turn, rate how well each banking organization is able to accurately rate the default experience of all of the bank's exposures.

Given adequate disclosure, standardization and centralized clearing, many of the ratings problems present today in the OTC ghetto will disappear and these securities will be followed and valued widely by the investor and analyst community. The agencies should consider the public good that accrues from compelling banking organizations (and also insurers, pensions and other systemically significant financial institutions) to invest only in assets and exposures where disclosure of all underlying data and models is required.

Once such a standard is in place and supported by the regulatory and ratings community, the origination behavior of issuers and Sell Side firms would change of necessity. Rather than trying to adapt classical ratings to illiquid and opaque OTC securities, we feel it is better to use a new internal ratings discipline for banking organizations to drive changes in market structure in terms of transparency, standardization and the simplicity of deals.

b. Possible Alternatives to Credit Ratings in the Risk-Based Capital Standards

Question 2: What are the advantages and disadvantages for each of these general approaches? What, if any, combination of the approaches would appropriately reflect exposure categories and the sophistication of individual banking organizations? What other approaches do commenters believe would meet the agencies' suggested criteria for a creditworthiness standard? If increasing reliance is placed on banking organizations to assign risk weights for credit exposures using the types of approaches described above, how would the agencies ensure consistency of capital treatment for similar exposures? How could the use of third-party providers be implemented to ensure quality, transparency, and consistency?

First, it seems obvious from reading the relevant portions of Dodd-Frank that the agencies and the banking organizations they supervise must develop their own methods of rating/valuing exposures independent of the ratings community. We support the elimination of all reference to NRSROs in current regulation and the substitution of a regime where banks would start with an assumption of 100% risk weighting for all exposures and then rebut that assumption using internal ratings criteria *established by regulators*. Once the banking organization has established its own internal rating for the exposure, it could then reference external ratings to test its results and follow the exposure forward in time.

Ironically, such a change would return the Basle framework back to a more robust approach focused on internal underwriting of credit risk as opposed to the reliance upon third parties to perform such work. In general, we believe that banking organizations and other financial institutions subject to prudential supervision have an affirmative duty under COSO, Sarbanes-Oxley and 12 CFR to be able to value/rate any exposure which they acquire or sell. We believe that the point of all of the changes mandated by Dodd-Frank is common sense, namely to shift the primary task of doing the work of valuation and rating back onto the banking organization.

In this regard, we would recommend that the agencies place strict limits on the ability of banking organizations and other financial institutions to contract with third-party service providers to obtain quantitative data, such as probabilities of default, as part of their process for making creditworthiness determinations and assigning risk weights. Allowing such services to support the bank's internal rating process defeats the point of requiring banking organizations to produce internal ratings and essentially allows the continued reliance by banking organizations upon NRSRO ratings under a different guise. Allowing such a loophole would be a direct violation of the terms of Dodd-Frank.

We believe that banking organization must have basic internal ratings competency in all of the products which they own and trade. Once that duty of preparing and maintaining internal ratings is performed, then the banking organization or other financial institution can test its work by using a range of ratings and external valuation advisors in the markets, not just the NRSROs. Some of the best valuation talent in the financial industry, the agencies should recall, resides with independent advisors and Buy Side funds.

Consistency of Capital Treatment

One of the key issues raised in this ANPR is how to achieve "consistency of capital treatment" in a world where banks are self-rating OTC exposures which are illiquid, entirely unique and deliberately not standardized. How indeed. One of the lessons that regulators need to take from the last several years is that the fact of the "innovative" OTC marketplace essentially renders capital adequacy regulation irrelevant for these products. By embracing instruments that are by design opaque and illiquid, valuation and thus risk rating becomes problematic, either from an investment or regulatory perspective. Simply stated, in times of market stress, the liquidity risk from OTC instruments trumps the underlying credit issues.

c. Exposure-Specific Options for Measuring Creditworthiness

Question 3: What are the advantages and disadvantages of these alternative methods? How can the agencies ensure consistent and transparent implementation? Should the agencies consider other international organizations? Which financial and economic indicators should the agencies consider? What are the implications or potential unintended consequences? Are there other methods for assessing risk-based capital requirements for sovereign exposures that would meet the principles described in section III? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

i. Sovereign Exposures

Consistent with our comments above, we believe that any banking organization which cannot demonstrate the ability to model P(D) for sovereign obligors should be prohibited from investing in such exposures. We believe that the explicit intent of Dodd-Frank is to end the use of third-party ratings as the primary factor in asset allocation and/or credit decisions. This implies that the banking organization must be able to internally value and risk weight any asset that it chooses to put onto its balance sheet or sell.

The third option listed in the ANPR regarding risk weighting sovereign exposures is the only approach that makes any analytical sense. The first and second options are essentially the current system with some superficial changes. Is it really possible that personnel from the agencies wish to give all nations that are OECD members a free pass when it comes to risk-weighted assets? Frankly, membership in the OECD and/or the G-20 does not seem to be a very robust measure of credit risk. Some of the largest OECD members such as Japan and the U.S. are on paths to default on public sector obligations, yet the major rating agencies still treat the long-term obligations of both nations as investment grade.

Due to political pressures, the published credit ratings from the top-three rating agencies for many OECD countries seem to understate the likelihood of default. If you compare the average debt spreads of many G-20 nations with their ratings from the top-three agencies, the market indicators suggest much higher P(D) than the ratings suggest.

Our preference in terms of methodology for rating sovereign borrowers is a simple cash flow analysis for each obligor, revenue vs. expenses, and then classical debt coverage ratios. We do not suggest that banks should not use external ratings, simply that the internal analysis of the sovereign issuers conducted by the banking organization or other financial institution must be the primary driver of the investment decision. This represents a significant change from current practice, where the third-party ratings providers were often the sole data input used for both asset allocation and credit decisions.

We believe that the agencies, along with the SEC, should explicitly remove any language from regulations mandating the use of one type of rating agency by any financial institution. Instead, the banking or other organization should be required to demonstrate primary competence in valuation and risk weighting of its assets. Then it may employ third-party vendors to support the analytical framework it creates for asset allocation and/or credit decisions. Of note, the agencies may have an opportunity in guiding this self-rating process to impose sufficient standardization on OTC products to begin to create a rational framework for generating risk-weighting factors that support capital adequacy analysis.

Question 4: What are the advantages and disadvantages of these alternative methods for calculating risk-based capital requirements for PSE exposures? How can the agencies ensure consistent and transparent implementation? Which services and businesses, or financial and economic measures, should the agencies consider? What are the implications or potential for unintended consequences? Are there other methods for assessing risk-based capital for PSE exposures in a relatively risk sensitive manner that would meet the principles described in section III? Commenters are asked to provide *quantitative as well as qualitative support and/or analysis for proposed alternative methods.*

Our view is that the ratings for Public Sector Entities (PSEs) must be a function of the financial condition of the sovereign sponsor. In the post-WWII era, the economic profession has supported the idea that government sponsored entities which issue their own debt and have dedicated revenue sources are somehow autonomous and deserve separate credit ratings. In the post-Lehman world, however, with most of the PSEs in the EU and US on some form or another of sovereign life support, it seems silly to argue that PSEs should have superior ratings to the host sovereign. Thus the only question seems to be whether the PSE has an equal rating to the host or is subordinate in some way.

As in the case of sovereign ratings, we believe that banking organizations should be required to generate their own internal ratings for PSEs and then use external ratings to test these forward estimates. Frankly, given the political pressures regarding ratings for PSEs, we would prefer that banking organizations used market indicators to support internal ratings tasks, indicators such as bond spreads and/or credit default swaps instead of third-party ratings. Over time, regulators will gather valuable data regarding the management competency and the internal systems of banking organizations based upon how well they estimate and manage future credit risk. This is yet another reason that internal ratings will be a very important tool for the agencies to enhance safety and soundness.

iii. Bank Exposures

Question 5: What are the advantages and disadvantages of these alternative methods for calculating risk-based capital requirements for bank exposures? How can the agencies ensure consistent and transparent implementation? Which financial and market indicators should the agencies consider? What are the implications or potential for unintended consequences? Are there other methods for assessing risk-based capital for bank exposures in a relatively risk sensitive manner that would meet the principles described in section III? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

The current blanket rule for a 20% weight for bank exposures is archaic. There is no reason why banking organizations cannot generate an institution-specific rating for each institutional bank counterparty. While in the current environment it is probably necessary to give a large weight to the sovereign rating when assessing bank counterparty and credit risks for institutions based in Ireland, Spain or the UK, it also seems highly speculative to suggest that sovereigns will always bail out the banks that operate in their jurisdictions. This is the implicit assumption in the current approach to risk weighting bank exposures. As above, we believe that each banking organization must be able to generate a rating for all significant bank counterparties as part of their internal systems and controls. Also, we would be much more inclined to see banks use market-based credit indicators to validate internal ratings as opposed to whether or not the bank is domiciled in an OECD country.

iv. Corporate Exposures

Question 6: What are the advantages and disadvantages of these alternative methods? What are the implications or potential for unintended consequences? If all banking organizations are allowed to calculate their own capital requirements for corporate exposures, how can the agencies ensure consistent and transparent implementation (for example, where there may be material differences in how financial statements are typically presented or differences in chosen financial ratios)? What different approaches or other financial or market criteria would commenters recommend? Are there other methods for assessing risk-based capital for corporate exposures in a relatively risk sensitive manner that would meet the principles described in section III? Commenters are asked to provide quantitative, as well as qualitative, support and/or analysis for proposed alternative methods.

As a general matter, assigning a 100% risk weight to corporate exposures while assigning a 20% risk weight to banks seems ridiculous. Anyone familiar with the relative financial condition of banks and non-financial enterprises in the OECD countries would know that banks are largely decapitalized. The corporates are liquid and awash in cash. In this day and age, why would you assign a 100% risk weight to exposure to ExxonMobil and 20% to Bank of America?

We believe that banking organizations should be compelled to internally rate corporate exposures. In terms of external validation, we support the use of a combination of third-party ratings and/or indicators such as debt spreads as a far more reasonable approach to risk weighting corporate exposures. To earlier comments about internal ratings, the agencies could allow banking organizations to generate internal ratings and assign risk weights based on balance sheet or cash flow ratios, such as current assets to current liabilities, debt to equity, or some form of debt service to cash flow ratio (for example, current interest and maturities to current cash flow from operations).

v. Securitization Exposures

Question 7: What are the advantages and disadvantages of these approaches for calculating risk-based capital requirements for securitization exposures? How can the agencies ensure consistent and transparent implementation? Which parameters or measures of subordination and structure should the agencies consider? What are the implications or potential for unintended consequences? How can the agencies ensure that an alternative approach meets the criteria for a creditworthiness standard? What other approaches or specific financial and structural parameters that would be appropriate standards of creditworthiness for securitization exposures? Commenters are asked to provide quantitative as well as qualitative support and/or analysis for proposed alternative methods.

See earlier general comments about OTC markets for complex structured assets. Banking organizations should only create and/or buy securitization exposures that afford disclosure of all data that is material to investors and that allow the banking organization to value the security internally. Of all of the alternatives, developing a risk weighting based upon a supervisory formula that is a function of the bank's ability to model and track such exposures seems to be the most promising alternative in the ANPR. As noted previously, if the agencies take the position that banks must be able to *demonstrate to their supervisors* the ability to rate any securitization exposures, then the "problem" of ratings for securitizations goes away.

vi. Guarantees and Collateral

Question 8: What are the advantages and disadvantages of the alternative approaches? What are the implications or potential for unintended consequences? Are there other approaches that would more appropriately capture the riskmitigating effects of collateral and/or guarantees without adding undue cost or burden? Commenters are asked to provide quantitative as well as qualitative supporting data and/or analysis for proposed alternative methods.

Please refer to sovereign comments above. The agencies should end the blanket risk weighting approach for guarantees issued by OECD governments with investment grade ratings and subject all guarantors to a stand-alone credit analysis and internal rating.

d. Burden

The agencies have received many comments about the "burden" of the changes that are required to current regulations by Dodd-Frank. To us, such arguments are disingenuous and misleading. Banks which argue that an internal rating of a given exposures is too burdensome or costly to produce and maintain should recall that these skills are part of the basic competency of owning and managing banks. Organizations that cannot perform these basic tasks efficiently and at a *lower cost* that purchasing such opinions from third-party vendors do not deserve to be allowed the privilege of working in this industry.

For too long the agencies have tolerated an environment where banks make asset allocation and investment decisions based upon ratings that they neither understand nor are able to replicate. Dodd-Frank now prohibits such reckless behavior and arguably makes any bank that cannot internally value and risk-weight all of its exposures liable for being accused of unsafe and unsound practices. In view of the losses to banking organizations and the FDIC deposit insurance fund caused by the mis-rating of RMBS and complex structured assets, we believe that regulators need to take a tough line on the issue of ratings in order to help banking organizations regain credibility with the public. The changes in the use of ratings required by Dodd-Frank are as much a challenge for regulators as for the banks they regulate.

We will be happy to answer any questions regarding these comments.

Yours sincerely,

Christopher Whalen
SVP & Managing Director

Appendix A

Bank Stress Ratings: Assets

(Billions of $)

	A+	A	B	C	D	F
2010 06	$2,164	$2,837	$4,942	$1,337	$465	$1,458
2010 03	$2,109	$1,295	$6,622	$1,088	$381	$1,843
2009 12	$1,457	$1,826	$3,072	$1,839	$295	$4,601
2009 09	$1,756	$1,938	$4,316	$584	$94	$4,535
2009 06	$2,005	$2,097	$4,132	$518	$68	$4,458
2009 03	$3,202	$3,131	$3,587	$729	$86	$2,784
2008 12	$2,366	$5,398	$403	$694	$46	$4,033
2008 09	$2,907	$5,504	$525	$704	$144	$3,772
2008 06	$2,897	$5,256	$400	$695	$51	$3,983

Source: FDIC/The IRA Bank Monitor

Bank Stress Ratings: Banks

(FDIC Insured Units)

	A+	A	B	C	D	F
2010 06	3,551	1,575	480	463	77	1,632
2010 03	3,676	1,592	504	480	93	1,534
2009 12	2,978	1,539	480	432	85	2,441
2009 09	3,308	1,481	410	429	77	2,337
2009 06	3,518	1,449	417	421	72	2,256
2009 03	3,959	1,431	452	437	88	1,820
2008 12	3,918	1,448	376	390	98	2,003
2008 09	4,498	1,293	315	356	63	1,793
2008 06	4,884	1,323	329	326	66	1,458

Source: FDIC/The IRA Bank Monitor